Modern Corporation Finance

MODERN CORPORATION FINANCE

by William H. Husband, Ph.D.

General Manager
Federal Savings and Loan Insurance Corporation

and James C. Dockeray, Ph.D.

Professor of Finance
The George Washington University

FIFTH EDITION

1962

RICHARD D. IRWIN, INC.
HOMEWOOD, ILLINOIS

FIFTH EDITION

First Printing, February, 1962

Library of Congress Catalogue No. 62-9133

PRINTED IN THE UNITED STATES OF AMERICA

PREFACE

THIS fifth revision of *Modern Corporation Finance* continues the basic approach and pattern of the previous four editions—recognition and analysis of both the external and internal facets of corporate financing. While it is common to appreciate the force and effect of environment upon human behavior, there may be a tendency to ignore this influence upon business operations. The relationship may often appear to be remote, but hindsight now reveals in no uncertain terms that the practicality, as well as the ideology, of corporate conduct has felt the impact of changing national and international conditions.

The significance of financial management has also been sharpened by these same pressures. We live in times of great decision; and, possibly more than we may casually appreciate, judgments are commonly formed on the basis of financial effect. Moreover, somewhat paradoxically, finance is a means of both initiative and reckoning; similarly, it is a medium of conservation as well as utilization. These basic concepts will be refined in the opening chapter, which discusses the nature of finance, and will become more evident later as we study the many phases of corporate financing.

Unlike the scientist whose answers are in many ways forced upon him by the inexorable workings and progression of formulas, financial management is constantly confronted with alternatives and the uncertainties of human and market response. Even so, there are basic principles to guide the course of financing, and it will be our purpose to relate them to the more evident forms of practice. This will be done by the use of numerous illustrative cases, which often have significance in their own right, as well as guideposts for the entire area of activity.

Although the differences between the academic and practical considerations of finance are patent, it is believed that the less colorful ties of mutuality are more significant. Academic treatment should represent the objective analysis of a problem and the results should meet the test of practical application. This characteristic has been proven forcefully in the field of science, and there is evidence of progress in achieving a similar form of liaison in the business area. It is our hope that this volume will contribute to the further realization of this goal, and that it will be of value both to students of finance and to those engaged in financial activities in a vocational or professional capacity.

While assuming the final responsibility for the views set forth, the authors wish to express appreciation to those who have submitted constructive suggestions, particularly Professors James Whitsett of Texas Christian University and J. Eugene Pierce of the University of Tennessee.

WILLIAM H. HUSBAND
JAMES C. DOCKERAY

Washington, D.C.
February, 1962

TABLE OF CONTENTS

PART IV. SALE AND REGULATION OF SECURITIES

PART V: INCOME AND WORKING CAPITAL

PART VI. CORPORATE EXPANSION

PART VII. FAILURE AND REORGANIZATION

PART I ►

Finance and the Corporation

Chapter 1 ►

THE NATURE OF FINANCE

OUR STUDY of corporation finance may well begin with a consideration of its basic nature. It differs from personal finance not only in magnitude but also in the qualitative and fiduciary features of the operations. In turn, unlike government finance which is dependent in the long run upon the power of taxation to produce the necessary revenue, corporate finance must at all times prove its own self-sufficiency. In earlier years, the financial performance of a corporation was shaped mainly by the capacity of management to meet the competitive pressures of the market, and the social order was taken for granted. Today, corporate management must take into account the powerful influences of dynamic social movements throughout the world.

In many respects, the study of corporation finance is an inquiry into the actions and policies of management. And management is no longer confined to prudent "housekeeping" of internal corporate affairs; more important, it must reckon with many elements over which it has little if any control. To give day-to-day reality to the thought, we need only mention the dramatic impact of the prolonged cold war, the transitions generated by scientific and technological research, the influence of powerful labor unions, and taxes which may often constitute the differential between liquidation and survival.

FINANCE AND THE ECONOMIC SYSTEM

Since financial activities are only a part of the larger economic system, it must be apparent that the type of general economy determines their basic pattern. While a free-enterprise form of business activity has been generally taken for granted over a long period of time, the trends since the early 1930's have created numerous and deep conflicts with tradition. Governmental participation in the economy is no longer an easy question of academic interest. In Russia, the government is a guiding and controlling force of economic, as well as political, affairs; in nearby Cuba, the government only recently conscripted most of the major types of business enterprise; and, in our own country, there is a large amount of indirect

support and underwriting of business by government and, indeed, there is some direct participation in businesses having a broad public interest.

Under both private and public ownership, the functions of finance remain—raising of capital, administration of income, and commitment of funds generally—but there is a vital difference in their significance to society, as well as in the manner of their practice. Under private ownership, finance offers an acid test in which failure becomes a cause for reckoning. Under public ownership, resort to taxes makes it easy to escape the rigors of financial performance; and the occasion to put responsibility to the test of solvency may become remote or may be lost in the broader area of governmental function. With private enterprise, the search for capital is dependent upon market response and the ability to retain earnings; in the case of public ownership, it may be a matter of legislative authority and subsidy.

Probably the outstanding difference between a private economy and one that is directed by public authority is found in the freedom of individuals to engage in business activities. Under the former, it is believed that the creative power and diversification of individual action should result in maximum benefit to society; under the latter, it is contended that directed effort by central authority provides controls that can be exercised to minimize the inevitable economic risks. Particularly at stake are the objectives of stabilizing business activity and of avoiding excessive unemployment. However, it is likely that no system can produce stability without adjustments or sacrifices, which may in the long run be more severe than the evils that are the object of correction. Whatever the plan of operation, there is a "price tag," which is better anticipated in advance than mourned in the clearer light of hindsight.

FINANCE—A FORCE OF ACCOMMODATION AND DISCIPLINE

Looking further into the nature of finance we may observe that, somewhat paradoxically, it is a force or medium of both accommodation and discipline.

Features of Accommodation. First, our system of financing provides the means of assembling funds that are necessary to initiate a new enterprise. Often the nucleus of the venture will be found in capital provided by the sponsor or owner, but, where there is promise of successful expansion, it is necessary to attract supplementary funds. As we shall note later in this volume, this may be done by enlargement of the ownership base as well as by borrowing money from financial institutions or by sale of securities to the public. The terms and arrangements for the procurement of additional capital by relatively new companies may often be stringent, but these are mainly the result of gearing the financial inducements to the related risks of the enterprise.

Features of Discipline. All activities require directional force or discipline to reach desired objectives. In business, finance serves as a quiet,

but inexorable, governor of operations. As shall be explained more fully in Chapter 13, management must ever be alert to the need for synchronization of operating needs with financial accommodation; stated in other words, there must be a sense of business and financial rhythm. However, erratic movements in the economy can easily create discordance and require compensating adjustments in financial arrangements. Or debt may mature when capital-market conditions are unfavorable, which may then compel management to resort to measures of expediency or improvisation.

Management must also have constant awareness that business conditions and the constituent enterprises are in a state of continuous change. In turn, it should be recognized that problems are best resolved by prevention than by cure; to this end, management should ever be looking forward, and it must have a working plan to meet various contingencies. Lines of credit are established with commercial banks to meet short-term developments, and refunding of existing debt may often be used to relieve pressures on the long-term capital structure. For the sake of clarity, we may note that long-term debt is commonly known as "funded debt"; its replacement is then naturally entitled "refunding." Also, as we shall see later in this volume, refunding takes place frequently for opportunistic reasons; if favorable capital-market conditions exist, the outstanding obligations may be called and replaced by new securities bearing a lower rate and terms more favorable in other respects.

We should note carefully, however, the meaning and scope of discipline. As used above, we have considered mainly its positive qualities—the maintaining of order and the keeping of operations in balance. Needless to say, failure to achieve these results brings into play the more popular concept of discipline—punishment or chastisement. In business, the latter consequences take the form of reorganization or liquidation of the corporation. The development of such serious actions naturally reflects the capacities of those who are responsible for the operations as well as the responsiveness of any particular enterprise to changing social and economic conditions.

THE ACID TEST OF FINANCIAL CRITERIA

As indicated, financial arrangements play a vital role in shaping and determining the soundness and success of business operation. But the real test of financial criteria over the long run is the making of a profit. In turn, profit is much more than a return or reward for risk-taking; more significantly, it is a crucial differential which determines whether or not any enterprise can survive. All too frequently we become enraptured by the drama of spectacular individual gains and fail to appreciate the economic function of profits in the aggregate.

Analysis of Profits Test. It should be stressed that the mere making of a profit does not prove, *ipso facto,* the success or durability of business operation. There is also need to appraise its qualitative characteristics.

How is the profit made? Is the profit generated by efficient operation or by momentary advantage? Is the profit realized by meeting the rigors of competition or by exploiting a monopolistic position? In short, is the basis of the profit solid or flimsy? Temporary gain may be pleasing to the particular beneficiary but, more significant in this day and age, is the larger criterion of the effect upon the aggregate economy. Profits made by special interests at the expense of the general economy are likely to generate later baneful results, but profits which promote the welfare of the public and the economy give buoyancy to true progress.

Profits and the Social Order. It is true, as indicated earlier, that the basic pattern of the economy gives shape to the business system, but, at the same time, the *modus operandi* of business has reacting and profound effect upon the nature of our social order. All too frequently it may be assumed that there is a conflict between public and private interests; actually, there is a mutuality of welfare, and, in the long run, one cannot prosper at the expense of the other. Unless private interests in the aggregate are prosperous, the state and the people it represents lack the wherewithal to promote the public welfare.

Perhaps we should recognize, too, that there may be a tendency by some schools of thought to regard profits as antisocial. Of course there are abuses of the profit system, but these should not cause us to overlook its larger and functional nature. As mentioned earlier, profits are an important "differential of balance" which serve to maintain the soundness and the integrity of the economy. They are a test of self-sufficiency or self-maintenance; and programs or systems cannot long endure unless they sustain themselves. Serious abuse or exploitation of the profit motive can bring harm to public welfare and, to a degree, this feature may have been present in the garish developments of the twenties. Indeed, it may have been a contributing factor to the serious and prolonged depression of the thirties. In any event, we can now be certain of one key point—there is a vital relationship between deep-seated social movements and business operation.

THE NEED FOR PERSPECTIVE

Today, more than ever, there is need to study corporation finance with a deep sense of the larger setting. Our times are feeling the impact of dynamic and far-reaching developments, and finance is inevitably reacting to the evolving pattern of business operation. Indeed, finance is being used as a medium to facilitate or accommodate changing demands; at the same time, its own motivations and practices are necessarily being molded by the new conditions brought into existence.

In the light of this background, it is particularly important to appreciate the role of finance. In essence, it is a tool and means of management without which no activity—be it public or private—can succeed. Finance

enables management to make the necessary adjustments to meet the demands of changing conditions, and it provides a means of control to reach desired ends. Lacking central and organized direction, there are aimless drift and uncertain result. The nature and responsibilities of management will be discussed at some length in Chapters 15 and 16, but, at this time, we may make a few preliminary observations.

MANAGEMENT OUTLOOK

In considering the role of management, we may first take note of the sweep or scope of its outlook. Naturally its primary and direct responsibility runs to the organization under its charge, but, even so, the discharge of this function is vitally dependent upon the general economic and business climate. Buoyant business conditions may conceal the deficiencies of management for an extended period of time; then, in times of adjustment, there is sure cause for reckoning.

To meet modern pressures, management must look far beyond the confines of its own immediate jurisdiction; otherwise, it will lack true perspective to evaluate the state of internal affairs. Technical direction and supervision of the flow of funds into and out of a business enterprise is not enough because outside factors may create conditions that can easily upset the balance of any particular company.

Visualization of the picture may be sharpened by noting the governmental scene which portrays so vividly the influence of foreign affairs upon domestic well-being. In somewhat comparable manner, business enterprise must be aware of the larger environment of which it is a part. Today's manager must be much more than a technician; rather, his is the role of a private business statesman. He must keep abreast of world conditions, of governmental policies, of public opinion, and a host of other elements that make up the environment in which business is conducted.

CONFLICTS OF THOUGHT

In applying the above concepts of management to the practicalities of business operation, we become involved in many conflicts of thought that may perturb all of us. On the one hand, we are naturally trying to preserve the cherished freedom of small, individual enterprise which has long characterized our economy; on the other hand, we are groping for solutions to the problems created by spectacular scientific developments and by the pressures of world disturbances. The latter, particularly, call for strength and force of action which, almost of necessity, compel us to use business organizations of great size.

One feature that generates particular conflict of opinion is the role of the federal government. In many respects, it is functioning as an invited, but unwelcome, guest; we want the benefits of its action in the

economic arena but are reluctant to accept the inevitable consequences. A variety of demands are being imposed upon government, ranging all the way from backstopping or supporting the economy to the protection of special and limited interests. Illustrative of the latter is the assistance extended by government to small business in the form of technical advice, financial accommodation, and favored tax treatment. Nor is big business lacking in its demands for recognition—relief from monopolistic restraint, placement of government contracts, and various forms of tax benefits.

RELATIONSHIP BETWEEN PUBLIC AND PRIVATE INTERESTS

Although concern for the public welfare may seem to be of an altruistic nature, it is our contention that management must consider this factor for its own protection. Involved is the key question of whether there is a conflict between private and public interests. One authority contends that consumer interest and public interest have much in common but declares that the "producer interest and the public interest are far apart." [1] Probably the underlying reason for this point of view is the assumption that the public interest is concerned with long-term result while the producer is motivated mainly by short-term gain. However, with the increasing size of corporations, management must more than ever concern itself with ultimate as well as immediate effects. At least, private-producer interest may be nurtured and assured, in the long run, only by the simultaneous existence of a sound and progressive society. We need only recall the baneful effects of prolonged depression to recognize the key importance of what may be termed the *common* welfare.

NATURE OF PUBLIC RESPONSIBILITY

The public responsibility of private financial management is of a twofold nature—direct and indirect. Its direct responsibility is readily defined although not always easily put into practice. In brief, it is the exercise of prudence and care which are quite properly required to operate on a safe and sound basis. This does not mean avoidance of the reasonable and inevitable risks of business operation, but it does mean that there should be a careful evaluation of the financial results. More pointedly, the object is that of making a profit—which, as indicated earlier, has qualitative as well as quantitative significance. Moreover, in the background, there should be a deep consciousness of the fiduciary aspects of handling other people's money.

The second or indirect responsibility is more nebulous in character and, consequently, not as easily defined. Most of our discussion of this

[1] See Clair Wilcox, "The Consumer Looks at Competition," *Consumer Reports*, Vol. XX, No. 9 (September, 1955), pp. 431–44.

point is reserved for the final chapter, but it may be noted here that the activities of financial management necessarily have effect upon the general economy as well as upon the corporation that is being managed. For example, to what extent does private management have responsibility for solving unemployment problems? While the answer may not be reduced to simple terms, it is clear that under the social conditions of our day, someone must meet this continuing challenge. Failure of private industry to provide a remedial program can only mean further extension of governmental activity which, in turn, weakens in the long run the foundation needed for a private-enterprise system.

Another area of indirect responsibility is found in so directing or formulating the pattern of private endeavor that it remains consistent with the principles of free enterprise. Monopolies are generally admitted to be obnoxious to the long-term welfare of private interests; and, indeed,

> . . . concentration of power in private groups leads inevitably to pressure for expansion of the powers of government. Capitalism as a system and freedom as an ideal are dependent upon the diffusion of power in the making of decisions which involve the people's energies, their resources, and the order in which their wants are to be satisfied. One of the requisites to the attainment of such aims is that the direction of investment be left largely to individuals and that management, so far as modern conditions permit, be left to owners.[2]

EMERGING PROFESSIONAL STATUS

In earlier times, management functioned somewhat like the captain of a ship who takes the sea for granted. Then the thirties revealed in no uncertain terms that the general economic climate has profound effect upon the welfare of each participating unit. In the forties, World War II demonstrated in still a different way the dependency of private business firms upon the tides of national welfare. Beginning with the early postwar period, and down to the present time, we have actively cultivated the philosophy that general economic welfare is the concern of all of us.

Out of this new economic philosophy there is developing an increasing belief that management is assuming the status of a profession. In turn, the code of ethics and the conduct which govern a profession assume a scope that extends far beyond the mere making of money for a single enterprise. This concept is particularly applicable to the management of large organizations whose policies and actions are commonly evaluated in terms of their effect upon the aggregate economy. For example, the price of steel in recent years has been given wide attention as a factor contributing to inflation.

The emerging professional status of management is giving rise to many questions about the various devices used to attract management personnel.

---

[2] Report of the Subcommittee on Investment, Joint Committee on the Economic Report, Congress of the United States, *Volume and Stability of Private Investment* (Washington. D.C.: U.S. Government Printing Office, 1950).

Do options to buy stock at favored prices encourage quick, speculative policies, or do they promote long-term benefits? Should managers trade in the stock of their own companies with inside knowledge of facts not known by the stockholders? These and other questions will be discussed at length in a later chapter dealing with executive compensation, but they are noted here in order to establish a background of thought for our study of corporation finance.

DECISION MAKING

In coping with the diverse elements presented by today's conditions, management is put to a severe test. The success of its performance is determined by a feature of long standing—the capacity to make decisions. The task of making decisions may appear simple to those who may advise the course of action to be followed by others; but, where there is direct and pressing responsibility for the results, we can be sure that the burden is onerous, to say the least. We should understand, too, that sound decisions can never be the product of momentary impulse; rather they arise out of the background of experience, and they must be founded in studied basic policies.

THE NATURE OF POLICY

Because of the intangible nature of policy, it is not easy to appreciate its force as a directive of operations. Yet it is the main determinant of practices for both private and public organizations. Again, for dramatic example, we need only refer to the foreign policy of our government; we know that out of its workings will come either war or peace. While private policies are seldom brought into such sharp focus, they still determine the shape and manner of the responsive operations.

Even though policies may not be reduced to writing (and they should be), they are nevertheless formulated by the current of activity over a period of time. For if we fail to adopt policies of our own choosing, they are forced upon us by the pressure of events. In turn, the latter is created not only by developments within the limited area of business operation, but, today, they arise out of the almost continuous flow of new and changing governmental programs. The latter have also given rise to a wide variety of opportunity for new business; at the same time, they have profoundly affected the complexion and character of private business dealings.

MANAGEMENT RESPONSES

One basic policy adopted by management on a wide scale to meet the diverse problems posed by our modern economy is akin to a familiar rule

in sports—the best defense is a good offense. Certainly the concept of conservatism has undergone a drastic change; instead of pursuing policies designed to shield a company from the dire potential of severe depression, there is an aggressive effort to move forward in the belief that sound growth will provide its own protection. Illustrative of the point are the comparative policies of Montgomery Ward and Company and Sears, Roebuck and Company. Until a few years ago, the former maintained a better-than-normal position of liquidity and refrained from establishing branch outlets on a broad scale; the latter moved with vigor to keep pace with the expanding economy.

At times, the strategy of moving with the times may be upset by shifts in the general economy or by management oversights, but it is generally recognized that proper growth is necessary to maintain the soundness of any enterprise. In the pursuit of this policy, there is need to avoid the pitfalls of simply making growth a fetish; instead, management must be careful to maintain the proper balances in order to assure the soundness of the program.[8]

Growth may take the familiar form of increased volume of the same general line of goods, but there is increasing favor of expansion which provides either diversification of products or achievement of greater control of the flow of incoming raw materials or outgoing finished goods. The form and nature of expansion will be discussed at length in Chapter 28; at this time, we may simply note the basic motivating influence—the realization that no business can stand still or simply maintain the status quo.

REFINEMENT OF FUNCTIONS OF FINANCE

Because of the affinity of management and finance, it follows that the former should have deep appreciation and broad knowledge of the nature of the latter. In piloting the course of travel of any specific enterprise, it is necessary to evaluate the larger environment. For this reason we may reduce the functions of finance to more specific terms and consider related features of their nature and applicability.

Finance, in its over-all sense, embraces many areas other than corporation finance—money, banking, and credit of various types and classes. Considered as a whole, finance may be said to be the circulatory system of the economic body, making possible the needed co-operation between the many units of activity. In an organism composed of a myriad of separate enterprises, each working for its own end but simultaneously making a contribution to the system as a whole, some force is necessary to bring about direction and co-ordination. Something must direct the flow of

[8] See G. Walter Woodworth, "Zeal for Rapid Economic Growth Could Be Tragically Self-defeating," *Commercial and Financial Chronicle*, Vol. 191, No. 5962 (June 23, 1960), p. 1.

economic activity and facilitate its smooth operation. Finance is this catalytic medium. It is largely intangible in its manifestations and is so intermingled with other economic forces that there is difficulty in appreciating the part that it plays. Yet, in reality, financial operations are a constant force of liaison among and within the units of enterprise.

Transactions between business enterprises are seldom on a cash basis and, for this reason, need to be financed. This is seen in the familiar manufacturer-wholesaler-retailer relationship, which is facilitated often by dealings of long standing. The prompt dispatch of goods and services through this channel is indicative of the undercurrent of finance which makes exchange possible. In everyday language, the financial arrangements are commonly referred to as "terms of credit." They almost always precede the transaction and pave the way for the actual transfer of the goods. Many financial relationships exist because one business unit may find it inconvenient to provide the necessary cash. In some lines of business, the manufacturer is best able to arrange for financing; in others, it may be the wholesaler. However, even if every unit could easily furnish its own capital, it would still be true that many, if not most, transactions would be on a credit basis because of the convenience of deferred payment, as well as other advantages.

A similar pattern is found in transactions between units of business within a like classification. In the broad field of manufacturing, relationships between producers of primary and of secondary products are typical. Here, as in the basic distribution process, many types of credit transactions are to be found. Some represent, in effect, the provision of necessary capital by one business for the benefit of another. Others are purely of the facilitating, convenience type. But, whatever the immediate purpose, finance aids in bringing about co-operation and efficient dealings among business enterprises.

RELATION TO FIELDS OF ENTERPRISE

In its broadest sense, corporation finance applies not only to manufacturing and trading enterprise but, in addition, includes railroad and public-utility financing. Each field, however, has distinctive operating features which affect the nature of its financing. Attention will be called to important variations having an industry origin, but our chief purpose will be to develop general financial principles of broad applicability. Most financial dogmas have a universality that cuts across business lines, and variations are more a matter of degree than a form of substantive difference. For instance, many basic principles of finance apply with equal force to areas as divergent as private industry and government. Market operations do tend to segregate business in terms of industry categories, but the primary basis of classification arises from characteristics of income and assets. It follows that financial activities are often

classified along similar lines for purposes of convenience, although this in no way affects the universality of the financial principle.

RELATION TO SIZE OF CORPORATION

The size of a corporation is another factor which has a bearing upon the nature and pattern of finance. First, we may note the psychological attitude displayed by the public generally. On the one hand, there is a tendency to admire the accomplishments of bigness; on the other hand, there is a desire to support small business for democratic reasons—and possibly because of the familiar feelings for the underdog. Formal expression is given to these sentiments in our national legislation; not only are restraints placed upon monopolistic practices, but also positive programs are established to assist small business (see Chapter 17). Inevitably the financial management of corporations is affected by federal legislation and its administration.

Second, irrespective of the applicable laws, size injects influence in its own right. Large corporations are better known on a national scale and, if they have established a favorable record, their securities obviously have greater acceptability by both investment institutions and private investors. In addition, many of the costs of floating new issues are approximately the same irrespective of the amount involved; hence, it follows that they will constitute a smaller percentage as the size of the offerings increase. This feature is applicable to many phases of the business operation and is perhaps most commonly recognized in the competitive positions of small retailers and chain stores in the field of distribution.

Third, size tends to engender a concept akin to the distinction drawn between the major and minor leagues in the sports world. Of course, the lines are not so clearly drawn in the financial arena, but there is recognition of the potency of size itself. For example, in early 1961, the American Telephone and Telegraph Company sold additional stock (see pages 366–68) of almost $1,000,000,000 in a single offering. While this financing is the largest private flotation on record and is not typical even of large corporations, it does serve to show that the acts of a single major corporation can exercise considerable influence on the economy.

As a corollary feature of size we should also point out that in our study of corporation finance, attention will be given to the activities of specific enterprises as well as to the larger aspects of financing as a whole. Frequently, the practices of a single corporation are of significance as a revelation of broad financial policy rather than as an expression of policy limited to the particular company. Conversely, general financial movements may mean much to the individual enterprise. This is simply the old story of understanding the whole by analyzing the parts and, vice versa, comprehending the parts to better advantage by being conscious of the whole.

OTHER CONSIDERATIONS OF SIZE

In depicting the prominence of relatively large corporations, there is no intention of minimizing the importance of smaller organizations. The latter are a necessary complement of the former for both social and economic reasons. On a broad social basis, the large corporation takes on a public significance which cannot be ignored. For instance, if a single massive corporation controlled all economic activity, it would obviously assume many of the characteristics of a sovereign state. Indeed, the corporate form is used as an instrument of government. While monopolization by one company does not exist, either in a single or in all fields of business, the narrowing of economic activity to a relatively small number of concerns does inject the question of the need for governmental controls. Consequently, in the interests of preserving a private economic system, large corporations have much to gain by encouraging the existence of smaller enterprises.

There are also practical business reasons which favor operation on a small-scale basis. While many large corporations seem to defy the familiar economic law of diminishing return, it is undoubtedly true that many activities can be performed more efficiently by small than by large companies. In general, the efficiency of small-scale operations tends to increase as the amount of capital investment required for the purpose tends to decrease. The recognition of need for so-called "small business" is seen in the observation of one authoritative business group that "one of the basic realities of our economic life is the interdependence of *all* business. The big firm and the little firm, the big industry and the little industry—each needs the other. Each is a customer of the other. All kinds of business make up that living and growing organism, the American business system."[4]

While we shall place greater stress on the financial operations of the large, rather than the small, corporations, the latter will by no means be excluded. Where appropriate, reference will be made to the special problems of small business; but, in general, reliance will be placed on the broad and common applicability of financial rules. Size, in many respects, is simply a factor of relative influence, although there are differences of importance in the applied techniques and in the availability of various facilities. Quite naturally, small companies would be in no position to resort to the large-scale financing practices of the larger concerns; but, even so, they must meet the expected tests of soundness.

CORPORATION FINANCE AND SAVINGS

As part of the broad, introductory approach to our study of corporate financing, we should recognize the underlying importance of savings.

[4] Committee for Economic Development, *Meeting the Special Problems of Small Business* (New York, 1947), p. 9.

Without savings there can be no growth, which is essential for the development of our economy, let alone the constituent units of enterprise. In turn, the source of savings is found in the diversion of earnings from current use to long-term investment.

While the foregoing concept is rudimentary in character, its application to the workings of our economy often results in many ramifications and conflicts of thought. On the one hand, there are those who stress the dangers of oversaving on the grounds that low-scale spending prevents the absorption of the maximum economic output; on the other hand, another school of thought stresses the dangers of undersaving because of the resultant curtailment of productive capacity. Out of these two positions has come the theory that depressions stem from the failure to put savings to work and that economic booms are the result of excessive use of credit which has created investment in excess of savings. However, it is likely that any well-developed nation will have either a degree of flexibility or a reserve capacity that can absorb fluctuations in the amount of savings. Serious cyclical disturbances are more likely to be brought about by a combination of circumstances which may involve factors other than economic.

As we probe further into earnings as the sole source of savings, it should be pointed out that both individuals and corporations participate in the accumulation of capital. In a sense, the origin of saving is found in the thrift of individuals who deem it wise not to spend all their income. To state it more accurately, these people plan their expenditures over a longer period of time than those who do not save. Instead of spending all the income realized in a current period, it is deemed advantageous to postpone its use until a later date—to educate children, to meet the needs of old age, to purchase various items requiring a substantial outlay of funds, or just to leave a legacy. During the interim of nonexpenditure, these savings become available for investment in productive plants or services—a large part finding their way directly or indirectly into corporations.

Once corporations are established and become going concerns, they, in turn, save or retain a portion of their earnings for purposes of meeting additional capital needs. At the present time, the bulk of our savings emanates from this source. During the five years ended December 31, 1959, it is estimated that the gross business savings amounted to $225,200,000,000, as compared with $73,785,000,000 reported for individuals in the main types of savings media.[5] In terms of ultimate effect, the savings by corporations still represent the sacrifices of individuals, since the people who own the corporations receive less in dividends than would be true if full distribution of the income were made. Consequently, it may be

[5] See, respectively, U.S. Department of Commerce, *Survey of Current Business* (Washington, D.C.: U.S. Government Printing Office), July, 1958, p. 7, and February, 1960, p. 16, for total private and personal savings; and Federal Home Loan Bank Board, *Source Book—Savings and Home Financing* (Washington, D.C., 1961), p. 15.

contended that corporate savings are to a large extent compulsory in character; at least, the stockholders are deprived of the opportunity to select other outlets for the investment of their funds.

OWNERSHIP AND BORROWED MONEY

Investment of savings in corporations may take form either in participation in their ownership or in a debtor relationship in which corporations promise to repay the funds at some future date. While detailed analysis of these two broad types of corporate investment will be made in a later section,[6] it may be noted here that ownership obligations are known as stock, and debtor obligations as bonds or notes. It is not uncommon to refer to the aggregate amount of stock and long-term debt as the "capitalization" of the corporation,[7] and to formal changes in their composition as "recapitalization." Although stocks may represent a permanent commitment of funds, and bonds often constitute an investment for a long period of time, it is likely that investors attach little significance to the comparatively fixed status of invested capital. Rather, for both stocks and bonds, reliance is placed upon market facilities enabling the transfer of commitments to other investors. As a result, there is a turnover of savings which, paradoxically, makes it possible to finance or carry long-term investments in assets and, at the same time, permits quick changes in the holdings of stocks and bonds.

There is pronounced difference in the market activity of bonds and stocks which is caused by both the difference in their nature and the constituency of their ownership. Bonds are naturally held in large amounts by a variety of institutions having charge of people's savings—banks, life insurance companies, pension and trust funds, etc. However, the average citizen plays a fairly active part in the ownership and market activity of common stock. This feature will be discussed more fully in Chapter 14 but, at this time, we may note the activity of small stockholders. For the year 1960, odd-lot transactions (less than 100 shares) on the New York Stock Exchange amounted to 164,546,000 shares, or 21.5 per cent of the round-lot sales (units of 100 shares) of 766,694,000 shares.[8]

The foregoing comments relate mainly to long-term securities and, for this reason, brief reference should be made to short-term placements of funds by banks and a variety of other creditors. Even here, it should be

[6] See Chapters 5–10, which describe the main types of securities.

[7] See Elvin F. Donaldson, *Corporate Finance* (New York: The Ronald Press Co., 1957), p. 330; Harry G. Guthmann and Herbert E. Dougall, *Corporate Financial Policy* (New York: Prentice-Hall, Inc., 1948), p. 74; and Chapters 12 and 13 of this volume.

[8] "The 1960 Odd-Lot Investor," *The Exchange*, Vol. XXII, No. 3 (March, 1961), pp. 5–7.

recognized that private savings, in a sense, may be said to provide the leavening which makes the extension of credit possible.

PRACTICE AND THEORY

Since there is a popular tendency to accent practical operations and to minimize theories, the relationship and importance of both to a proper understanding of corporation finance should be stressed. At times, the so-called man of practical affairs may belittle theoretical concepts because he considers them unworkable in day-to-day activities. It is true that selfish and extreme promotion of personal interests may create conflicts between theories and practices but, when viewed from the perspective of proper and sound finance, practices are but the manifestations of underlying theories or principles. Indeed, concepts of finance that cannot be supported by the test of applied action must fall because of their own emptiness; in turn, practices that cannot be justified by the basic logic of theory must also fail—albeit, at times, after there has been a loss of other people's money.

It may well be that misunderstanding of the practical values of theory is a matter of semantics. Although it may not be possible to resolve this familiar cause of difficulty, discussion can at least narrow the gap of disagreement. In many ways, true theories may be regarded as expressions of basic and controlling policies. To appreciate the import of the latter, we need only contemplate the plight of the accountant, the lawyer, the engineer, or the scientist who tries to function without the guiding and stabilizing influence of underlying principles. Similarly, the financier has no yardstick to measure his actions without basic and general criteria. Especially is this true of *modern* corporation finance because of the sweeping changes that have occurred in recent times.

OUR POINT OF VIEW

While our point of view may be indicated by the foregoing discussion, we may bring it into sharper focus in order to establish perspective for consideration of the ensuing contents of this volume. First, we shall assume that maximum private freedom in the operation of business enterprise is the desired pattern and that abundant opportunity should be created for the exercise of individual initiative. At the same time, it is believed that such a *modus operandi* can exist only by having private interests give recognition to public interests. Second, action by government should be directed to the prevention of abuses and to the exercise of a supplementary role to hold the economy in reasonable balance. Third, applying these two beliefs, we shall attempt to analyze the effects of private financial policies and practices on public welfare as well as on the corporation itself. To do otherwise would constitute failure to recognize

the realities of the age in which we live. Whether we like it or not, the activities of government are spreading into the field of business; and they must be considered and treated in the practical management of private business affairs.

In the light of these tenets, we believe that management must be grounded in basic principles and supplemented by broad knowledge of the general economy. Today, the crosscurrents of economic thought and international insecurity add to the complexity of the problem. For instance, monetary policies of the government have a direct effect upon the cost of capital raised by private industry; increased taxes arising from the enlarged scope of governmental activity change the complexion of the profit and loss account; and even production schedules, let alone foreign markets, are affected by the chaotic conditions which exist throughout the world. This vast overhang of disturbance and change must necessarily be reflected in private financial policies and practices.

Activities in financial transactions of a current nature greatly exceed those of a long-term nature; for this reason, many writers direct major attention to the former. However, it is our belief that all phases of financial operation should be viewed as part of the corporate whole, and that there should be keen awareness of the need to co-ordinate the financial program. It is true that there are special problems and techniques relating to the different facets of financing, but these will be considered only after we have established a background of understanding of the corporation itself.

Our approach will be broad rather than narrow and will encompass subjects having indirect as well as direct bearing upon a single corporate structure. The focal point is the financing of corporations, but we may sharpen our analysis by appropriate reference to the larger setting. We may begin the shaping of this perspective by observing the salient features of all pertinent forms of organization for conducting business activity. This is the purpose of the succeeding chapter in which we shall study the corporate form and review the nature of other means of business operation.

QUESTIONS AND PROBLEMS

1. Discuss the thought that the "study of corporation finance is an inquiry into the actions and policies of management."
2. Distinguish between the internal and external problems of management.
3. "The self-interest of management is the greatest guaranty of sound business operation." Discuss the merits of this view.
4. Discuss the problems of private business enterprise in the light of the various trends toward more active governmental participation in the business area: (*a*) Do you think there should be any governmental activities in the business area? (*b*) Should the activities be limited to periods of business adversity? (*c*) Should government attempt to stabilize business?

5. Discuss the observation that "Under public ownership, resort to taxes makes it easy to escape the rigors of financial performance."
6. "Finance is a force that both stimulates and restrains business action." Discuss.
7. In your opinion, do governmental guarantees and supports weaken the sense of responsibility of private management?
8. Evaluate the role and nature of profits in our modern economy.
9. Discuss the interrelationships between the system of business operation and the nature of the social order.
10. Discuss the observation that "the direction of investment be left largely to investors and that management, so far as modern conditions permit, be left to owners." What conditions would militate against this principle?
11. "Large corporations must be more fully aware of the public interest than small corporations." Discuss.
12. How may the size of a corporation affect its financing?
13. Explain the statement that "most financial dogmas have a universality which cuts across business lines." Suggest qualifications of this generalization.
14. What are the dangers of excessive concentration of industry: (*a*) geographically and (*b*) by ownership or control?
15. Discuss the arguments for and against treating management as a profession.
16. Evaluate the problems of "decision making" and of the formulation of broad policies.
17. Discuss the relationship between theories and practices.

REFERENCES

BERLE, ADOLPH A., JR. *The Twentieth Century Capitalist Revolution*, chap. ii. New York: Harcourt, Brace & Co., 1954.

BUCHANAN, N. S. *The Economics of Corporate Enterprise*, pp. 11–28. New York: Henry Holt & Co., Inc., 1940.

DRUCKER, P. F. *Big Business*. London: William Heinemann, Ltd., 1947. *Fortune*, Vol. LII, No. 1 (July, 1955), pp. 96–97, "Box Score of Business Bigness."

JOINT COMMITTEE ON THE ECONOMIC REPORT, SUBCOMMITTEE ON INVESTMENT, CONGRESS OF THE UNITED STATES. *Volume and Stability of Private Investment*. Washington, D.C.: U.S. Government Printing Office, 1950.

KAVESH, ROBERT A. and MACKEY, JUDITH. "A Financial Framework for Economic Growth," *The Journal of Finance*, Vol. xvi, No. 2 (May, 1961), pp. 202–25.

LAVENGOOD, LAWRENCE G. "American Business and the Piety of Profits," *Harvard Business Review*, Vol. xxxvii, No. 6 (November–December, 1959), pp. 47–55.

PHILLIPS, JOSEPH D. *Little Business in the American Economy*, chaps. ii, iii and vi. Urbana, Illinois: The University of Illinois Press, 1958.

TEMPORARY NATIONAL ECONOMIC COMMITTEE. *Bureaucracy and Trusteeship in Large Corporations*. Monograph No. 11. Washington, D.C.: U.S. Government Printing Office, 1940.

Chapter 2 ►

FORMS OF BUSINESS ORGANIZATION

THE FORM of organization involves in large measure the manner in which the entity of a business is established. Even when an individual conducts a business in his own right and name, the activity still has its own claim to identity. It may bring the individual large financial returns, or it may be the cause of impoverishing his entire family; but the fusion of personal and business interests eliminates in no way their separate capacities. Indeed, the importance of business is such that it may be given special legal recognition, with varying degrees of divorcement from the personal ownership.

Because of its wide range of adaptability for individual use and economic advantage, the corporation has become a device of ever-increasing significance in facilitating the detachment or identification of various forms of activity. It is a common form of organization for municipal governments as well as for many agencies of the federal government, and in the private area, the corporate form may be used for both nonprofit enterprises and the operation of business for profit. Our interest is confined to private enterprise operated for profit; and, except for purposes of observation, we shall limit our study of the corporation to this particular use. For perspective, we may first take note of other possible forms of business organization.

THE INDIVIDUAL PROPRIETORSHIP

As the term suggests, the individual proprietorship is a business venture which is sponsored and managed by a single person. More businesses are operated in this manner than in any other way, typifying our free-enterprise system of economy. Even today, the immigrant to our country—let alone our native citizen—finds it possible to enter business freely on his own initiative and, if successful, to accumulate more wealth in a few years than he was previously able to save in a lifetime. Economic hazards may show heavy odds against success, but legally there is a large de-

gree of freedom in getting started. There may be nominal license fees and requirements to prove fitness in some forms of activity; but, in general, the individual is relatively free to move in his own behalf. These sole proprietorships are legion—gas stations, barber shops, building companies, the professions, and a host of other familiar small enterprises—and their diversity reflects the variety of modern living. All are directed toward making a living and entertain the hope for additional profits.

Complementing the freedom of the sole proprietorship are the risks and limitations that are inevitably related to this form of organization. The debts of the business are equally the obligations of the individual in his personal capacity; indeed, he is subject to the full force and responsibility of unlimited liability. Also, except for his credit, he is limited to his own resources; and his opportunities are restricted in corresponding degree. There are the few exceptions where individuals have achieved the success of large volume; but, for the most part, it must be apparent that one-man enterprise does not provide a base sufficiently broad to meet the demands of modern large-scale operation.

THE PARTNERSHIP

Consistent with its ordinary meaning, a partnership simply represents a joining of interests by two or more individuals in a common project or venture. Again, the participants act according to their own best judgment, for there are no special statutory requirements covering this form of organization. Usually, so-called "articles of partnership" are drawn in order to fix the terms of agreement and to minimize the possibilities of later misunderstandings. Various features should be covered in a partnership agreement, such as (1) the respective investments of the partners, (2) the division of profits or losses, (3) the manner of control, (4) the terms of admission of new partners and of dissolution, (5) the division of liabilities, and (6) other items pertinent to business conduct.

Because of their specific and limited nature, new articles of copartnership should be drawn to effect any change in the membership. In actual practice, partnership agreements may provide that in the event of death or withdrawal of a partner, the partnership may be assumed to have been dissolved by reason of law but, that in fact, it is not dissolved; under these conditions, there may also be provision for the admission of a new partner satisfactory to the surviving members. Generalities covering the validity of such provisions of expediency are difficult, and the acid test of any particular agreement would be found in a suit making reference to the specific facts.[1] At the same time, it should be recognized that many

[1] See 40 *Am. Jur.*, Partnership, Sec. 285–87. In Sec. 287, it is stated that "Where, as is often the case, the articles provide that the partnership shall not be dissolved by the death of a partner, such provision will be given effect by the courts." However, in the same section, there is the qualification that "Where the articles of copartnership provide for the continuance of the firm business by the surviving part-

business transactions are effected on the assumption that resort to legal action is a remote contingency or is simply part of a calculated risk.

The impetus for the creation of business partnerships usually stems from the desire of a sole proprietor to expand his scope of operations, to add additional talent, to acquire additional funds, and to diversify the risk, as well as from other miscellaneous reasons too numerous to mention. Needless to say, the combining of individual effort may also arise in connection with an entirely new venture. Since the partnership does not have a legal existence separate and apart from its individual members, it is apparent that mutual faith and purpose of the participants are essential for success. The acts of a single partner bind the group, and each is liable without limit for all the debts of the partnership. It is true that the members may attempt recovery from each other, but the articles of partnership have no binding effect upon outside parties. In short, the partnership form of organization means that the potential risk of each member is equivalent to the total losses which may be suffered by the firm.

As a means of moderating the unlimited liability which is inherent in partnerships, many states have provided for the creation of limited partnerships. Under this plan, at least one partner is subject to unlimited liability; but the others may obtain relief by meeting the requirements of the statute and filing a copy of the partnership agreement in the public records. Filing the agreement in this manner facilitates giving notice to the public, which is essential if the limitations are to be recognized. As in a general partnership, transfer of the individual interests is not possible; and the use of the partnership form of organization for business purposes has all the inconveniences of this rigidity. As a result, it may be said that the partnership arrangement lends itself to the needs of small business or of special ventures; but it does not offer any special advantages which would encourage its use for the purposes of large-scale operation.

THE JOINT-STOCK COMPANY

Unlike the sole proprietorship and the partnership, which are common plans of business organization, the joint-stock company is an unusual form of operation. Even so, its nature may be described briefly for informative purposes as well as to show the wide latitude which is available to individuals for the operation of business enterprise. Formed by a contract between the participants, it is comparable with the partnership in this respect; at the same time, however, the capital investment is represented by shares that make the ownership interests transferable.[2] A cur-

---

ners and the personal representatives of any member of the firm who may die, it seems that while such an agreement will be binding on the surviving partners, the representatives of the deceased partner are not bound thereby."

[2] Because of its hybrid character, a joint-stock company is defined in various ways, for example: "A *quasi* partnership, invested by statutes in England and many of the

rent example of a joint-stock company is the Adams Express Company, which was organized in New York State on July 1, 1854.[3] Unless the company is dissolved by law or by action of its members, its articles of association provide that its existence will continue until June 1, 1998. As indicated by its name, the company originally engaged in the railway express business; but, for some years, it has operated mainly as an investment trust.

The use of the joint-stock company form of organization is undoubtedly restricted by the absence of broad, covering statutory authority and the unlimited liability feature of the shares.[4] It may be formed irrespective of statutes and operates in accordance with the rights and principles of common law. This feature may suggest ease in organizing a joint-stock company; but, at the same time, there is a resulting atmosphere of uncertainty about its status. On the one hand, the unlimited liability characteristic of the shares makes it a quasi partnership; on the other hand, its capacity to continue regardless of specific ownership interests makes it akin to a corporation.

THE MASSACHUSETTS TRUST

One other form of business organization which is available without formal chartering by governmental authority is the Massachusetts Trust.[5] It is so called because of its origin in this particular state; but, in essence, it is nothing more or less than a result of the application of the principles found in any legal trust. Owners of funds and other property turn their holdings over to trustees, who issue certificates or shares of ownership. Indeed, there may be shadings of preference as to classes or types of ownership; and new flotations of securities may be made in the future for the purpose of raising additional capital. In short, the trustees would direct and manage the trust fund in a manner comparable to the functioning of the directors of a corporation.

---

states with some of the privileges of a corporation"; "A partnership whereof the capital is divided . . . into shares so as to be transferable without the express consent of the copartners"; and "Such associations are not pure partnerships, for their members are recognized as an aggregate body; nor are they pure corporations, for their members are more or less liable to contribute to the debts of the collective whole." See *Bouvier's Law Dictionary* (Rawle's 3d rev.; Kansas City, Mo.: Vernon Law Book Co.; St. Paul, Minn.: West Publishing Co., 1914), Vol. I, pp. 1704–5.

[3] See *Moody's Bank and Financial Manual,* 1960, p. 549.

[4] See *Bouvier's Law Dictionary,* p. 1705, for exception in state of New York, where "joint stock companies have all the attributes of a corporation except the right to have and use a common seal . . . ; but it has been held that the provisions in the New York statutes are merely local in their operation and that the members may be sued in other states as partners; *Boston & A. R.* v. *Pearson,* 128 Mass. 445; *Frost* v. *Walker,* 60 Me. 468."

[5] An example is the New England Gas and Electric Association, which functions strictly as a holding organization; another is the Amoskeag Company, which has most of the characteristics of an investment trust.

Ordinarily, the liabilities of the owners are limited to the amount of their investment; and their shares enjoy the privilege of transferability. However, the life of the trust is generally restricted so that it may not exist in perpetuity—the expiration usually becoming effective at the end of the period of time stated in the trust agreement or upon the death of specified individuals. The trust arrangement may also provide considerable freedom in transacting business within all states, and it usually escapes various taxes levied upon corporations. With such advantages, the query is natural as to why the trust is not a preferred form of organization in comparison with the corporation. In brief, it may be said that the statutory enactments applying to corporations provide a basis of certainty which may be lacking in the case of trusts. Also, it is probable that there would be difficulty in building public support for a form of organization which lacks statutory controls.

THE CORPORATION

It would be easy to assume that the corporation is the simple and natural progression resulting from the development of the forms of business organization previously described. Probably some influence has come from this source; but, in much greater measure, the corporation is the product of social and business needs. Its nature and early origin will be discussed in the next chapter; at this time, emphasis may be given to its organizational features.

A salient feature of the corporation as a form of business organization is its impersonal nature. Although personal incentives create the moving forces leading to its creation, the corporation has an objective cast which is not found in either the sole proprietorship or the partnership. The corporation is much more a studied plan or a means of facilitating business operations. In the words of one authority: "The matter is a functional one, not one of social ethics. But to the extent that it is functional, all other aspects of the matters are subordinate. The special interests or needs of individuals who occupy some place in the corporate structure are inferior in importance to the functional effectiveness of the corporation itself."[6]

Despite the impersonal or legal nature of the corporation, it does take on a personality or assumes an "image" in the public mind. Not only does it become known by the products and services sold but, in addition, it is characterized by the manner in which it operates. Indeed, the corporation has been described as "a cross-section of humanity"; and that it is "the sum total of the talents, the energies, and the characters of the human beings of which it is made, mellowed by the traditions and the experience of other human beings who have gone before."[7]

---

[6] Jackson Martindell, *The Scientific Appraisal of Management* (New York: Harper & Brothers, 1950), p. 137.

[7] Advertisement of E. I. du Pont de Nemours and Co. (Inc.), Detroit Free Press, January 11, 1959, p. D15.

ADVANTAGES OF THE CORPORATION

It is no exaggeration to say that the corporation has been one of the major agencies making possible the scale of economic progress which has characterized modern times. Because of this importance, as well as the fact that an appreciation of the nature of the corporate form is essential to any study of corporation finance, its advantages should be well understood. In summarized form, the corporation offers the following benefits: (1) recognized legal entity; (2) continuity of existence; (3) limited liability to owners; and (4) facilitation of large-scale production.

Recognized Legal Entity. The separate and distinct personality of the corporation is both real and vital to the conduct of business. By having a legal entity, the corporation may engage in business in its own name, hold title to property, sue and be sued, and exercise many other rights of an individual. Not only does the existence of a separate entity permit the corporation to act in its own right, but it also contributes materially to the other advantages of the corporation. Especially does it facilitate the continuity of a business enterprise and make possible the limited liability of the shareholders.

To appreciate the force and deep significance of the entity concept, distinction may be made between the "corporation aggregate" and the "corporation sole." The former "consists of many persons united together into one society, and kept up by a perpetual succession of members, so as to continue forever"; the latter "consists of a single person who is made a body corporate and politic in order to give him some legal capacities and advantages, especially that of perpetuity. . . ."[8] While the corporation sole is used rarely for private business operation and is found generally in governmental and church affairs, "as, a minister seized of lands in right of the parish," it does serve to reveal in a striking manner the separation of "capacity or office" from the membership or personal interests. Out of this legal recognition of a distinct and separate entity arises the innate power of the corporation to continue forever. Transfers of interests contribute, of course, to the practicalities of bringing this about.

Continuity of Existence. Returning to the main subject of our attention—the corporation aggregate—continuity of existence is made possible by the privilege of the stockholder to transfer his shares. Transfer may be effected at the discretion of the shareholders alone, without the advice of either the corporation or its officers. The corporation or its agent simply executes a new certificate in the name of the new owner and cancels the old stock. The continuity of the corporation is made obvious by its contrast to the uncertain life of the partnership. In the event of the death of one of the partners, the organization is automatically dissolved. On the other hand, it is possible for all the stockholders of a corporation to die; and the corporation still retains its existence and identity.

---

[8] *Anderson's Dictionary of Law* (Chicago: T. H. Flood, 1889), p. 262.

The continuity of existence of a corporation may be limited by the laws of the state from which it received its charter. In the early period of corporate development, each corporation obtained its charter by special legislative enactment; and the charter usually provided for perpetual existence. Later, when the practice of special enactment became burdensome, the various states provided a standardized procedure for the granting of charters; but to retain a semblance of control, the laws frequently stipulated a definite period of years as the life of the charter. However, upon expiration of the term, there is usually a renewal of the charter if its provisions are in accord with the laws existing at the time. This gives the state added control over the corporation by making it possible to require amendments to the charter at periodic intervals. At the same time, limited-term charters may create uncertainty about the continuity of existence, and perpetual charters have become the general rule.

Limited Liability to Owners. The corporation provides limited liability for its shareholders, although this is not inherent in the form of organization. Instead, the protection is conferred by specific statute. The statutes creating corporations could require either unlimited liability or such other liability as might appear expedient. An illustration of the former is found in the earlier California corporation laws, which provided that the shareholders would be liable for their proportionate share of unpaid debts. Over a long period, the shareholders of banks were quite generally held liable in an amount equal to twice the par value of their stock. In the thirties, the federal laws were amended so that the stock of national banks would be limited in liability to its par value, and most states have made similar amendments to the laws applicable to state-chartered banks.

The total liability of the shareholder in a business corporation is usually restricted to the par value or initial purchase price of the stock, but it should be noted that the corporation itself has unlimited liability. To make this clear, the following balance sheet may be assumed:

Assets	$5,000,000	Current liabilities	$1,000,000
		Bonds outstanding	1,000,000
		Capital stock	1,000,000
		Surplus	2,000,000
	$5,000,000		$5,000,000

In the event of failure, the liability of the corporation is not restricted to its capital stock of $1,000,000. As far as the corporation proper is concerned, there is no expressed limit of liability; and the creditors would have prior claim against the entire $5,000,000 of assets. Limitation of liability applies only to the shareholders of the corporation. In the foregoing illustration, the shareholders would have no further liability if the stock were fully paid; however, if the corporation had not received the full amount of the par or stated value, the holders of the stock would be liable for assessments equal to the difference between the paid-in and par

amounts. In turn, failure to meet this obligation would be grounds for peremptory sale of the stock and the use of a sufficient amount of the proceeds to meet the deficiency.

The limitation of liability is obviously a privilege intended to encourage the promotion of business enterprise and to aid the attraction of private investment in the form of venture capital. At the same time, special privilege may be justified only on the basis of its ultimate effects on the public welfare. Granting that unscrupulous promoters may have taken advantage of this attribute of the corporation to escape personal liability, nevertheless it is believed that the larger benefits to the public greatly outweigh the abuses that may occur by reason of restricted liability. Among the advantages to the public interest, the following two may be cited:

1. New enterprise is encouraged because of the greater freedom from risk, and the resulting expansion of business is expected to be of benefit to society.

2. By eliminating the threat of additional liability, the attraction of ownership capital from the public at large is facilitated; and dependence upon borrowed funds is lessened. The resulting benefits to the general economy may not be measured statistically, but there can be little question about the strength provided by a larger base of ownership. Not only does a larger ownership or equity interest lessen the risk of loss to creditors but, in addition, it enlarges the capacity of the enterprise to absorb adverse developments.

Speaking generally, it may be said that the limitation of liability eliminates considerable nuisance and inconvenience to the public as well as to the sponsoring interests of business enterprise. Uncertainty has an enervating effect in all walks of life, and the business area is no exception.

Facilitation of Large-Scale Production. The corporate form of organization greatly facilitates large-scale production because it is able to obtain the substantial capital necessary to conduct large-scale operations and because it aids the establishment of an efficient management program. Management may be both subdivided and delegated to a great degree. In a partnership, assignment or allocation of authority is made difficult by the powers and rights attaching to the individual partners. Each partner is able to bind the partnership to the limit of its resources and may encroach further upon the resources of the partners as individuals. In the case of corporations, the manager and officers have only the status of agents. Again, the board of directors is likely to be more diversified and representative than the corresponding group of most other forms of organization. Corporations are also generally larger and, hence, able to obtain the best management talent available.

The corporation is unexcelled as a medium for raising large amounts of capital. Both the limited-liability feature and an efficient technique for acquiring capital through the issuance of stocks and bonds in various-sized units serve to attract funds. This should be increasingly evident as

the life and characteristics of a corporation are more completely reviewed.

INTERRELATIONSHIP BETWEEN FINANCE AND ORGANIZATION

The form of organization affects in pronounced manner the financing of business enterprise, particularly the important elements of risk, income, and control. In the financing of all types of organization, these incidents of ownership are present in varying degrees. Any form of organization that affords greater flexibility of these elements of ownership facilitates the financial process. For example, if a form of organization permits the modification or lessening of the risk element to the investor, it is evident that capital may be more quickly attracted. Similarly, the ease with which control may be concentrated, or at least made more effective, should increase the efficiency of operations. This feature may be abused, but when employed legitimately, "controlled" control offers many benefits to both management and investor. Finally, the division and assignment of income on the basis of stipulated preference are a direct outgrowth of the form of organization and may be used to advantage in the attraction of capital funds.

THE CORPORATION AS A MEDIUM OF FINANCING

Those qualities of the corporation which facilitate the financing of business may now be set forth more specifically. First of all, a wide variety of classes of investors—such as the ultraconservative, the conservative, and the so-called "speculative" investor—may be reached. This diversified appeal is possible because of the many classes of securities which a corporation may issue and sell. Bonds that are protected by specific pledge of assets and with sufficient coverage of interest requirements may be sold to meet the needs of high-grade investment. Again, bonds may be issued when the margin of principal protection is slightly less or when specific pledge may be lacking but when interest requirements are comfortably earned. Such securities usually carry a higher yield and should appeal to those investors who are willing to accept a smaller degree of safety for the slightly greater return. Many of the debentures or unsecured bonds are in this classification. Upon occasion, the corporation may issue short-term notes to provide for temporary working-capital needs or to provide temporary financing until such time as it may be possible to borrow on a long-term basis at a lower rate of interest.

The second general classification—stocks—represents the ownership element in the corporation. The purchaser of stocks makes what is intended to be a permanent investment in a business, from which he may withdraw only through the sale of his stock to some other person. Stocks are of two general types: preferred and common. Unlike bonds, with

their fixed promise to pay interest and principal, preferred stock has some of the risks of ownership. It has priority over the common stock as to both dividends and liquidation of principal, but it is subordinate to all claims of creditors. Investors are generally attracted to this form of investment by a comparatively high rate of return combined with a sound financial position of the issuing corporation. From the point of view of the latter, preferred stock makes it possible to avoid the rigidity of fixed or mandatory charges because dividends, unlike interest on most forms of debt, are payable at the discretion of the directors without precipitating legal corrective action by the investors. For this reason, preferred stock may provide a convenient means of raising capital to advantage when favorable conditions prevail in the capital market.

Completing the pattern of securities is the familiar common stock, which carries with it both the risks and opportunities of final ownership. It offers the best and possibly the only means of sharing in the appreciation of values growing out of the secular trend, as well as in any improvement in the earnings arising out of changing price levels or expanding volume of business. When fortified by a demonstrated record of long-term performance, common stock may appeal to investors on a strictly financial or investment basis; and it often is used to create diversification in investment portfolios. It is frequently recommended as a hedge against inflation; but its successful use for this purpose may be affected by other conflicting elements, such as union demands for higher wages, higher taxes, etc.

It can be seen that the corporation is able not only to cater to a large variety of investment tastes, but its form permits the distribution of the incidents of ownership to meet the quantitative requirements of the many types existing within any class of investors. Because of the divisibility of the securities, the corporation can accommodate the needs of the small as well as the large investors. Stocks may be sold in lots of one share, 10 shares, 100 shares, or any number of shares. Stocks may be quoted on the stock exchange at less than one dollar a share or at several hundred dollars per share. In either case, the investor has the opportunity to buy any number of shares, be it one or a thousand. Bonds are not as universally within reach of small investors; but they are sold in a number of denominations, in some cases as low as $25 per bond, and are usually available in any quantity.

ADAPTABILITY OF THE CORPORATE FORM

The powers of corporations are so wide and the structure is so flexible that they may be adjusted to meet many diversified conditions. To illustrate the extremes in which the corporate form may be used, the "closed corporation" and the "consolidation" may be noted briefly. The former is illustrated by a corporation in which voting stock is not avail-

able to outside parties; in other words, the controlling ownership is *closed.* Under these conditions, there is substantial identity of ownership and management, and it is usually found in cases where friendly or family interests are dominant. The corporate form is adopted in order to effect a separation of business from personal affairs or to facilitate the administration of the business. A prominent example of a family corporation was the Ford Motor Company until early 1956, at which time it had assets of about $2,500,000,000. All the voting stock was owned by members of the Ford family, and the great bulk of the nonvoting stock was held by the well-known Ford Foundation.[9] By means of the corporate device, other property interests held by members of the family were detached from the risks involved in the manufacturing business.

In great contrast to use of the corporate form of organization for family or personal reasons is its use to achieve the consolidation of many enterprises. An outstanding example is the General Motors Corporation whose annual net income after taxes has on one occasion (1955) exceeded $1,000,000,000. By bringing together under a central top management a number of previously separate automobile companies and a variety of other corporations, there has been created, in effect, an industrial empire. The economic purpose of such consolidation is to acquire the advantages of centralized financing, engineering, and management, as well as to obtain many accessories and other supplies from wholly owned or controlled subsidiaries. In this case, however, a rather large degree of rivalry has been maintained among the different units of production.

DISADVANTAGES OF THE CORPORATE FORM

Realistic appraisal of the corporate form of organization makes clear that it is not without its disadvantages. Particularly is this true with respect to small business operators, who can well afford to weigh the inconveniences of legal formality, the added taxes which attach to the corporation, the restrictions on corporations in doing business in other states, and the uncertain credit status of a small company. On the other hand, large-scale business has little alternative in the selection of a form of organization, since the corporation is virtually the only possible medium for raising the required capital. However, the different states vary widely in their fees and taxes, as well as in the powers that are granted to corporations; but these features will be given more specialized treatment in a later chapter.

In general, it may be said that little advantage may be gained by incorporating whenever a person's business activity is also his major occupation for making a living. Illustrative of the point is the almost universal unincorporated status of the farmer. If the typical farmer were to incor-

---

[9] See pp. 238–39 for summary facts reporting the exact number of shares and further details of the transition from a closed to an open ownership basis.

porate, he would take on needless accounting detail and would be required to file various separate, additional reports; in the event he sought a loan, it is likely that the bank would require his own personal signature rather than being satisfied with the corporate obligation only. Similarly, the combination of a skilled trade and business—plumbing, electrical work, painting, etc.—seldom warrants the expense and inconvenience of incorporation. It is only when additional capital is desired, or when an individual has many activities other than his business, that it may be advantageous to establish a separate company.

TYPES OF CORPORATIONS

Not only is it of interest to the reader to know these characteristics of a corporation, but he also should be familiar with the many kinds of corporations. Restricting the classification to private corporations, the following types may exist:

- I. According to stock
  - A. With stock—usually for the purpose of making a profit in business operation
  - B. Without stock—usually for nonprofit purposes to provide a means of organizing and operating religious, educational, social and charitable activities
  - C. Hybrid—usually for the purpose of putting the operations on a mutual basis (No stock of any type may be issued, as illustrated by mutual savings banks and mutual insurance companies; or, shares may be issued, as illustrated by the large majority of savings and loan associations.)
- II. According to field of enterprise
  - A. Public utilities—water, gas, telephone and telegraph, steam and hydroelectric, local transportation
  - B. Railroads—best classified on geographical basis
  - C. Industrial—iron and steel, automobile, oil, electrical equipment, etc.
- III. According to nature of operation
  - A. Operating
  - B. Holding
  - C. Combination of A and B
- IV. According to place of incorporation
  - A. Domestic
  - B. Foreign

According to Stock. State laws provide for a wide variety of corporations to operate on either a stock or nonstock basis. They may be organized for either profit or nonprofit reasons and are commonly known as stock companies and mutual companies respectively; however, as indicated in the outline above, there may be exceptions in both types. Although corporation finance is mainly concerned with organizations of the stock type, it should be noted that development of the mutual form of enterprise has achieved considerable prominence as a means of conducting business or as a method of carrying on various types of group activity.

Fraternal and other social agencies are illustrative of the latter class of mutuals and give rise to business and financial problems only incidentally. However, in the former class—mutuals organized for business—the financial element may be just as important as it is in stock companies.

The mutual form of organization has achieved its greatest prominence in the fields of finance and agriculture. To note only the first of these two areas, mutuals account for a considerable share of the business in life insurance and other types of insurance, investment trusts, and some areas of banking—mutual savings banks and savings and loan associations. The second largest private corporation in the world is a mutual—the Metropolitan Life Insurance Company, with assets of more than $17,000,000,000.

While the term "mutual" suggests business democracy of the highest order, it is significant that companies of this type differ little in their administration from those of the stock type. They are subject to the same compelling and controlling financial drives. Voting, although usually limited to one or a specified maximum number of shares per member, is generally by proxy; and the management of mutuals acts in about the same manner as that of stock companies to preserve control. Indeed, in the case of mutual savings banks, the directors are self-perpetuating, that is, the directors make their own replacements. As in government, the "ins" quite naturally seek to justify and maintain their administration.

Responding to the dynamic pressures of day-to-day affairs, mutuals tend to become hybrid in their basic character as they increase in size and scope of operation. Differences in treatment of members are not unusual; and many financial measures are akin to those used by stock companies, including in some instances a form of preferred shareholder or member. Creditors have the same priority as they do in stock companies but generally account for only a relatively small amount of capital. The adoption of the co-operative or mutual principle as a basis of operation in private business would necessarily exercise tremendous influence on the financial pattern; but the functions of finance would remain in some form.

According to Field of Enterprise. Classification according to the field of activity is used particularly in investment analysis; but it is also of interest to the student of corporation finance in the following ways: (1) as a means of reducing corporations to a more systematized and coherent basis and (2) as a means of acquainting the student with the more important corporations. In connection with the first reason, it has been implied at various times that financial policy is frequently attributable to the nature of the field in which a concern is operating; and the classification of corporations according to specific fields should help to make this more clear. In connection with the second reason, students and others too often lack familiarity with the leading American corporations. To overcome this deficiency, it is suggested that understanding of financial policies may be sharpened by reference to actual cases whenever possible.

Attention should be called to the increasing difficulty of classifying corporations rigidly on the basis of a single field of activity. Especially is this true of the industrial category where there has been a marked tendency to establish diversification or greater control of the flow of materials as planks of financial policy. For the sake of example, we may note the following:

Diversification of Activity

United Shoe Machinery Corporation. The original and basic operations of this corporation are clearly indicated by its name, but, in recent years, it has extended its activities into atomic, automation, plastic, and other fields. Currently, more than a third of its sales are to nonshoe customers.

Textron Inc. Again, as the name suggests, the original business of this company was found mainly in textiles. Today, by means of stock control, its activities embrace automobile accessories, electronic products, and a variety of industrial and consumer goods.

Studebaker-Packard Corporation. Quite naturally we think of this company as the manufacturer of the Studebaker (Lark) and, formerly, the Packard automobiles. But it, too, has yielded to the diversification motif; in 1960, it purchased the Gravely Tractor Corporation which produces a variety of tractors and similar equipment.

Control of Flow of Materials

Atlantic Refining Company. Some five or six years ago the crude oil production of this company was equal to only about one half the amount used by its refineries. To correct the imbalance and effect more control over incoming raw materials, Atlantic acquired another company engaged in crude oil production and expanded its own activities toward the same end.

Corn Products Refining Company. This is another company which is popularly recognized by one of its many products—Karo syrup. Expansion in this case has been in the direction of greater control over the sales outlets. Illustrative is its acquisition of Best Foods, Inc., a well-known organization with a variety of food products.

According to Nature of Operation. From the standpoint of operations, corporations may be divided into operating companies, holding companies, and a combination of the two. An operating company is one that is actively engaged in the production of goods and services. Broadly speaking, it might be said that active operation is the normal function of corporations and that any other function is more or less an adulteration of the true purpose of corporate activity. The holding company is a corporation organized for the express purpose of holding stocks of other corporations. It may be distinguished from an investment trust in that an investment trust is interested in holding stocks for their income and appreciation possibilities, whereas in the holding company the primary interest is the co-ordination and control of the subsidiary corporations. Absolute control is possible only when the holding company owns one share more than 50 per cent of the stock of the company it wishes to control. Actually, because of the delegation of voting rights or the inactivity of shareholders, holding companies are able to exercise the desired influence with

far less than 50 per cent of the voting stock. In recognition of this fact, the Public Utility Holding Company Act of 1935 defined a holding company (for the electric power and natural gas industries) as being any company owning 10 per cent of the voting stock of a subsidiary, unless the company could show that in fact it did not exercise control. The law goes further and states that any corporation exercising control of a subsidiary is a holding company even when it owns less than 10 per cent of the controlling stock.

Irrespective of the organic nature of the corporate form, it is now being used rather commonly to serve in a dual capacity as both an operating and a holding company. Many American corporations, for example, hold the stock of subsidiary companies with foreign charters. Even for strictly domestic operations, expansion is often accomplished by purchase and holding of the stock rather than by merger. The examples are legion and are typified by most of the companies cited in our discussion of diversification and products control. Also, it should be said that the practice is found in all three of the basic areas of activity—industrial, public utility, and railroads.

The holding company is a good example of the resources that management interests may use to gain their ends. Designed to avoid the legal interference connected with other means of intercorporate control, the holding-company principle is widely accepted at the present time. In spite of its somewhat tainted conception, its use has proved a source of economical operation, as well as an easy way to achieve desired co-operation. Instead of being essentially a form of business organization, it has become a device for control. It occupies a large place in the field of corporation finance because of the close relationship existing between finance and control. At this time, our desire is not so much to consider the holding company as used for consolidation purposes as to recognize the corporate principles underlying such a concern.

According to Place of Incorporation. If a corporation is operating in the state from which it received its charter, it is known as a "domestic" corporation. If it operates in other states, it is classed by those states as a "foreign" corporation. Of course, this latter condition refers to strictly intrastate business, as all corporations are free to engage in interstate business without restrictions on the part of the individual states. Included under foreign corporations are also those corporations incorporated in foreign countries. Some writers have chosen to designate this group as "aliens."[10] The term has merit as a means of facilitating classification; but in state laws, this nomenclature is not applied.

---

[10] See Charles W. Gerstenberg, *Financial Organization and Management* (New York; Prentice-Hall, Inc., 1951), p. 5; H. A. Haring, *Corporations Doing Business in Other States* (New York: The Ronald Press Co., 1927); and others.

QUESTIONS AND PROBLEMS

1. Discuss the importance of the form of organization as (*a*) a functional unit of economic activity, (*b*) a facility of management, and (*c*) as an influence upon the means of financing.
2. Evaluate the social and economic advantages and disadvantages of widespread freedom in the organization of businesses as sole proprietorships or partnerships.
3. "The sole proprietorship and partnership have entities of experience even though they may not be recognized legally." Explain and discuss.
4. Would it be possible to restrict the unlimited liability of a sole proprietorship by contract between the parties in specific transactions?
5. Evaluate the practicalities of using the corporate form of organization for a small business.
6. Discuss the points that should be considered in drawing articles of copartnership.
7. Construct a draft of articles of partnership for a grocery firm to consist of three partners on the basis of your own assumptions covering the sharing of profits, the delegation of responsibilities, etc.
8. What form of organization other than the corporation may be used to achieve limited liability?
9. Discuss (*a*) the partnership qualities of a joint-stock company and (*b*) the corporate features.
10. "The 'corporate image' revealed in the mirror can never be anything else than a substantial segment of the public itself . . ." (Advertisement of E. I. du Pont de Nemours and Co. [Inc.]. Detroit Free Press, January 11, 1959, p. D15.) Discuss the significance of the "corporate image."
11. Refer to page 24, and evaluate the statement that the corporate form is a matter of functional use rather than social ethics.
12. Distinguish between the corporation "sole" and the corporation "aggregate."
13. Discuss the corporation as a factor in contributing to economic progress.
14. "Managing the affairs of a company 'with due regard to the whole field of human relations' is a violation of trust to the stockholders who invest their money in the company." Do you agree?
15. "The closed corporation is an unwarranted extension of public privilege to narrow private interest." Explain and discuss.
16. What are the reasons for subjecting public-utility companies to more stringent regulations than industrial companies?

REFERENCES

Berle, A. A., Jr., and Means, G. C. "Corporation," *Encyclopaedia of the Social Sciences,* Vol. IV, pp. 414–23.

Churchill, Betty C. "Business Population by Legal Form of Organization," *Survey of Current Business,* Vol. XXXV, No. 4 (April, 1955), pp. 14–20.

———. "Age and Life Expectancy of Business Firms," *Survey of Current Business,* Vol. XXXV, No. 12 (December, 1955), pp. 15–19, 24.

Drucker, P. F. *Big Business.* London: William Heinemann, Ltd., 1947.

FINN, DAVID. "The Price of Corporate Vanity," *Harvard Business Review,* Vol. XXXIX, No. 4 (July-August, 1961), pp. 135–43.

FULLER, W. "The Incorporated Individual: A Study of the One-Man Company," *Harvard Law Review,* Vol. LI, No. 8 (June, 1938), pp. 1373–1406.

MARTINEAU, PIERRE. "Sharper Focus for the Corporate Image," *Harvard Business Review,* Vol. XXXVI, No. 6 (November–December, 1958), pp. 49–58.

STEVENS, R. S. *Handbook on the Law of Private Corporations,* secs. 1–3 and 11, St. Paul: West Publishing Co., 1936. (This book will be referred to hereafter as *Stevens on Corporations.*)

Chapter 3 ►

BRIEF HISTORY AND NATURE OF CORPORATIONS

TO UNDERSTAND the nature and behavior of corporations, it is important to have some knowledge of their origin and the pattern of thought relating to their development. Private business corporations, as we know them today, are rather new phenomena when measured in the light of historical perspective; but their roots are deeply imbedded in long tradition. There is no exact point of time when it may be said that the corporation was discovered or was formally recognized as a form of group activity. Some eminent authorities hold "the view that associated rights and collective entity antedated individual rights and entity"[1] and that the corporate concept evolved from this source; others believe that the corporation was a deliberate and planned means "to meet the necessities of a changing society."[2]

NATURE OF THE CORPORATE IDEA

Although the time of the creation of the corporation is uncertain, it is probably true that "the germ of the corporate idea lies merely in a mode of thought; in thinking of several as a group, as one."[3] In other words, the key is found in the social and legal recognition of the "oneness" of group action. "When certain groups become active in daily life, especially in trade matters . . . ," there is little escape from giving legal reality to the "group capacity."[4] Emphasis should also be placed upon the importance or identification of the activity because the corporate idea may embrace even the separation of a single individual from some unique or distinct function under his control.[5] As a result, the corporation today

[1] William Meade Fletcher, *Cyclopedia of the Law of Private Corporations* (rev. and permanent ed.; Chicago: Callaghan & Co., 1931), Vol. 1, p. 2.

[2] *Ibid.*, pp. 2–3.

[3] Robert L. Raymond, "The Genesis of the Corporation," *Harvard Law Review*, Vol. XIX, No. 5 (March, 1906), p. 350.

[4] *Ibid.*, p. 354.

[5] Fletcher, *op. cit.*, p. 90.

is a convenient medium for the conduct of both large and small affairs.

It should be observed that legal confirmation is a vital requirement to make the distinction between a group and its component members truly effective. For example, it is common to think of the activities of a partnership in a group sense; but the absence of legal recognition limits the use of this form of organization for operation of business on a large scale. In other words, the corporation is dependent in large measure upon the legal powers which both create it and make its actions possible. As we noted in the previous chapter, the law is a cornerstone of corporate structure and, in a sense, gives "airy nothings a local habitation and a name."[6] Only the lawyer can interpret accurately the underlying foundation of law; but, at the same time, the layman must be cognizant and appreciative of its influence.

FACT OR FICTION

In defining a corporation, it is common to describe it as a legal fiction. For example, in one widely quoted definition, the corporation "is an artificial being, invisible, intangible, and existing only in contemplation of law."[7] Because of the frequency in referring to the corporation as a form of legal fiction, it is desirable to give some emphasis to its reality. Generally, "fiction" conveys the thought that nothing exists; yet we know from experience that the corporation is a fact in a very real sense of the word. We need only to recall that corporations account for a large part of the business transacted in the world today.

Obviously, the corporation is intangible in essence; but this is equally true of many other forms of economic objects or values. For example, property rights, which are generally expressed in the form of pieces of paper, have their deeper reality or meaning in their social and legal recognition. Possibly we are confronted with one of the many paradoxes which characterize our living. One authority is undoubtedly correct in observing that the "basis of all groups is merely a mode of thought . . . ,"[8] whereas there is equal justification for another authority to contend against the idea that the corporation is a "mere mental conception."[9]

ATTITUDE OF THE STATE TOWARD THE CORPORATION

As a foster child of the law, it is not surprising that the corporation is the object of more than usual attention by the state. At times, it is in high favor; and legislation is enacted to encourage corporate develop-

[6] See Raymond, *op. cit.*, p. 355.

[7] Fletcher, *op. cit.*, p. 12, quoting Chief Justice Marshall, *Dartmouth College* v. *Woodward*, 4 Wheat. (U.S.) 518, 636.

[8] Raymond, *op. cit.*, p. 350.

[9] Fletcher, *op. cit.*, p. 14.

ment. At other times, the corporation is in disfavor and is even viewed with distrust. In the early Roman days, there was some antipathy toward the corporation;[10] and this same attitude has appeared on various occasions in our own country. In our early history, particularly, the corporation was an issue that was subject to acrid debate as well as the familiar pressures for legislation. Generally speaking, corporations were deemed to contain the seed of monopoly; and this quality was then even more abhorrent than it is today. It must be remembered that not too many years had elapsed since a war was waged to establish the rights of individual freedom, and there was a general fear of any form of business organization which had the potential of great expansion and of almost perpetual existence. Corporations were also associated particularly with public functions, and their use for strictly private purposes was something of a novelty.

PRIVATE CORPORATIONS PRIOR TO THE YEAR 1800

It is reported that only 6 private business corporations of domestic origin existed during our colonial period and that only 20 more were added during the 13 years prior to the adoption of the federal Constitution.[11] By the end of the eighteenth century, it is likely that no more than 250 private business corporations were in existence; and practically all of them were of a quasi-public nature—turnpike companies, toll-bridge companies, water supply companies, banks, and insurance companies.[12] It is clear that the corporation was considered mainly as a device for enterprises that were engaged in services of a broad, public nature, and that manufacturing and trade operations were not presumed to have this status.

Using the words of that early period, the counsel for a manufacturing corporation declared in a court case that "the making and maintenance of a turnpike road is an affair of public concern and public convenience, seldom entered upon or prosecuted for the sake of the profit contemplated to arise to the undertakers. . . . Whereas a company of manufacturers cannot be presumed to have any object in view but their private or personal gains. . . . and they ask for an incorporation merely for the greater convenience in managing their affairs."[13]

All corporations at that time were the product of special legislative enactment, which means that each charter was granted only after a specific vote of approval by the assembly and concurrence by the executive branch of the state government. Illustrative of the prevailing atmosphere

---

[10] *Ibid.*, p. 4.

[11] *Ibid.*, sec. 3.

[12] *Ibid.*, p. 8; for further details, see Simeon E. Baldwin, *American Business Corporations before 1789* (Washington, D.C.: U.S. Government Printing Office, 1903).

[13] E. Merrick Dodd, "The Evolution of Limited Liability in American Industry: Massachusetts," *Harvard Law Review*, Vol. LXI, No. 8 (September, 1948), p. 1360.

is the petition of the organizers of the first manufacturing company in Massachusetts in 1789 asking "to be incorporated 'with such immunities and favors' as the legislators should think necessary. . . ."[14] The charter that was granted gave the "right to levy fines up to £50 for violation of 'such laws and regulations as may be necessary for the government of the said corporation' and the right to use their seal as a trade-mark and to sue infringers for treble damages."[15]

THE NEXT CENTURY

For much of the first half of the nineteenth century, a clarification of the rights and status of corporations was in the making. It began early when the Supreme Court of the United States, in 1804, rendered an important decision which alleviated public fears by its delimitation of corporate powers. In the words of Chief Justice Marshall, it was said: "Without ascribing to this body, which, in its corporate capacity, is the mere creature of the act to which it owes its existence, all the qualities and disabilities annexed by the common law to ancient institutions of this sort, it may be correctly said to be precisely what the incorporating act has made it, to derive all its powers from that act, and to be capable of exerting its faculties only in the manner which that act authorizes."[16] In effect, this decision meant that corporations did not have the power to act as natural persons but could do only those things which were granted by the laws enabling their creation.

The various states were also active in enacting legislation that affected the organization and operation of corporations. In Massachusetts alone, 11 charters were granted to manufacturing companies in the year 1809, compared with a total of 10 in the preceding 20 years.[17] By the year 1815, it "had chartered 115 textile companies and a considerable number of other manufacturing companies. . . ."[18] In considering the granting of these charters, the question of limited liability was frequently a point at issue. Moreover, the fact that companies were the result of separate legislative acts made it possible to treat them differently. For example, the charter of the Amesbury Nail Factory Company granted by Massachusetts in 1805 provided for unlimited liability; while the charters of a company created in 1807 and another created in 1808 contained no reference to this feature.[19]

The feature of limited liability as a corporate characteristic is so widely accepted today that we think of it as being inherent in the form of

[14] *Ibid.*, p. 1361.

[15] *Ibid.*

[16] *Head & Amory* v. *The Providence Insurance Co.*, 2 Cranch U.S., p. 127; 2 Law. ed., p. 229.

[17] Dodd, *op. cit.*, p. 1355.

[18] *Ibid.*

[19] *Ibid.*, p. 1363.

organization. However, in this early period, the charters were generally silent on this point, although, as indicated previously, express provision for unlimited liability to creditors was included in some instances. Shareholders were, of course, liable for assessments up to the amount of the subscription price or as needed when the shares were issued without a price.[20] Failure to meet these assessments resulted in the forfeiture of the shares and their sale to others. Since the assessments were a matter of management decision, they provided little security to the creditors.

Then, reflecting the critical public attitude toward corporations, legislation was enacted that specifically provided for unlimited liability. For example, the Manufacturing Act of 1809 in Massachusetts stated that ". . . if execution against the corporation could not be satisfied out of corporate property, it might, after a lapse of fourteen days, be levied on the body or property of any members."[21] Modification of the character of the liability took place by amendments to this basic act until 1830, when it was "provided that the shareholders should be jointly and severally liable for all corporate debts until the whole amount of capital stock, as fixed at the first meeting of the incorporators, should be paid in and a certificate of such payment should be filed in the Registry of Deeds."[22] This, of course, is not too different from the situation as we find it today when shares are issued for less than the subscription price.

Free incorporation statutes—those that give the right of incorporation to all individuals who meet the prescribed statutory requirements—did not make their appearance until near the middle of the nineteenth century. Because of the fear of corporate powers, it was deemed necessary to prescribe by charter the exact nature of their rights; and emphasis was placed on their use for a single purpose only. Care was taken to give accurate expression in the charter to the particular type of business which would be conducted, and any overstepping of the declared area of operations was considered a serious violation of legal authority. The corporate form became increasingly popular with the greater freedom provided by free incorporation laws, but it was not until the latter part of the nineteenth century that corporations took on a new and powerful momentum of their own. In effect, they became a sort of movement which has continued down to the present time; indeed, it is possible that future historians will characterize this brief interlude in our nation's history as one of corporate development and domination.

THE PICTURE TODAY

Current activity in the creation of new corporations is a far cry from earlier days when a single new organization was an act of some mo-

[20] *Ibid.*, p. 1357.
[21] *Ibid.*, p. 1364.
[22] *Ibid.*, p. 1370.

ment. Now the process of incorporation is streamlined and is largely a matter of legal routine. Corporations are regarded as a normal means of business operation, some 182,476 new corporations having been organized in the year 1960 alone.[23] It is little wonder that at least one state has been referred to as a "charter factory."

With new corporations currently coming into being at the rate of about 15,000 a month, it is easy to lose perspective because of the spectacular qualities of the action. At the same time, it is likely that the size and vigor of today's business require such fast-moving organizational

TABLE 1

NUMBER OF NEWLY ACQUIRED AND DISCONTINUED BUSINESSES, 1952–59*

(In Thousands)

Year	Newly Acquired Businesses		Businesses Discontinued†
	Newly Established	Acquired by Transfer	
1952	346	370	276
1953	352	378	299
1954	366	371	319
1955	408	384	314
1956	431	393	342
1957	398	376	335
1958	397	375‡	347
1959	423‡	§	347‡

* *Business Statistics 1959 Biennial Edition*, pp. 26–27 (updated), U.S. Department of Commerce, Washington, D.C.

† Total discontinuances would include those expiring as a result of transfer or the combined figures for columns two and three.

‡ Preliminary.

§ Not available.

procedures. Ours is the most gigantic of all economies the world has ever known, and we do big things with speed—as was so fortunately demonstrated in World War II. Even a quick look at Table 1, which shows the turnover for all forms of business in the United States, reveals a scope of activity which is surprising, to say the least. A comparison of the figures shown in this table with the number of new corporations mentioned above shows that the corporate form is still greatly outnumbered by the more simple sole proprietorship and partnership.[24]

[23] Dun & Bradstreet, Inc.; also, based upon this same source, the Small Business Administration reported 193,070 new business incorporations for 1959, as well as monthly averages for the period 1946 to 1959. The latter ranged from a low of 6,971 in 1951, to a high of 16,090 in 1959—see Small Business Administration, *Thirteenth Semiannual Report for Six Months Ending December 31, 1959* (Washington, D.C., March, 1960), p. 11.

[24] Analysis of federal income tax returns for active businesses with accounting periods ended July, 1957—June, 1958, in selected industrial groups reveals that: *corporations* comprised over 38 per cent of all in manufacturing, but only 12 per cent

RIGHTS AND POWERS OF CORPORATIONS

Although many corporations have evolved to a considerable degree from local to national institutions, their original grant of powers and rights still emanates from the individual states (also the District of Columbia and territories). The federal government may vitally affect the exercise of this underlying authority both by taxes and by regulation of interstate commerce, but it has engaged in the chartering of corporations only on a limited scale. Since consideration will be given at various points throughout the text to the manner and nature of federal controls, attention will be given at this time only to the primary sources of corporate authority. These powers of a corporation are found in the following: (1) rights and powers specified by law, (2) rights specifically stated in the articles of incorporation, and (3) implied rights. Reference may also be made to *ultra vires* actions.

RIGHTS AND POWERS SPECIFIED BY LAW

Rights of general applicability to all corporations are usually enacted into broad statutes, thus serving both as a source of authority for corporate enterprise and as due notice to the public at large. Powers such as the following are commonly provided: (1) to make contracts, as well as to sue or be sued; (2) to use a corporate seal; (3) to "purchase, acquire, hold, convey, lease, mortgage or dispose of property, real or personal, tangible or intangible"; (4) to borrow money and sell bonds or other evidences of indebtedness on either a secured or an unsecured basis; (5) to acquire, guarantee, etc., bonds and other evidences of indebtedness of other corporations; and (6) to perform such acts as are expedient to accomplish the stated purposes.[25]

Besides the grants of authority to corporations contained in formal statutes, there are the further powers arising out of the interpretations of constitutional and common law. While the latter are less evident than the former, they are both extensive and significant. In general, it may be said that a corporation has practically all the business rights of an individual when operations are conducted within a single state. However, it cannot freely enter another state and carry on operations without receiving permission or a special license, whereas the individual is not so restricted.

RIGHTS STATED IN THE ARTICLES OF INCORPORATION

The scope of rights expressed in the corporate charter necessarily may not extend beyond the authority established by the enabling statutes

of those in trade; *sole proprietorships*—47 per cent of manufacturing, and 75 per cent of trade; and *partnerships*—less than 15 per cent in both groups. See *Statistics of Income, 1957–58, U.S. Business Tax Returns* (Washington, D.C.: U.S. Treasury Department, Internal Revenue Service, 1960), p. 2.

[25] As expressed in the General Corporation Act of Ohio.

but, as indicated above, the latter now permit great latitude. In earlier times, the statement of purpose was simple; for example, the charter of the Pittsburgh Steel Company, issued by Pennsylvania in 1874, declared that "Said corporation is formed for the purpose of The manufacture of iron or steel or both, or of any other metal or of any article of commerce from wood or metal or both."[26] Gradually, over a period of time, increasing popularity of the corporation and the influence of legal prudence and preciseness led to both more detailed itemization of the powers and the inclusion of a broad, empowering clause to guard against possible omission of specific recital. Thus, the charter of the American Can Company, granted by the state of New Jersey in 1901, set forth such objects as the following:

> To manufacture, use, deal in, sell and otherwise dispose of, cans, packages, and receptacles of all kinds, sheet metals and metal ware of all kinds, and other things made wholly or partly of metal, tools and machinery for any of the manufacturers herein stated, and materials and products useful, or arising, in or in connection with, such manufacture and dealings.
>
> To mine, quarry, extract, dig, cut, reduce, treat, prepare for use, transport, traffic and deal in, ores, minerals, metals, wood, coal, peat, marl, clay, oil, gas, and raw materials generally, and their products direct and incidental.
>
> To carry on any other productive, manufacturing, commercial or transportation business, lawful for the corporation.

In the case of the Venezuelan Sulphur Corporation of America, chartered by the state of Delaware in 1954, there are 15 specific recitals of powers, of which the following may be noted:

> To engage in the business of mining, quarrying, extracting, boring for, pumping or otherwise acquiring ores, minerals, metals, timber, natural oils, and other substances derived from the earth or water, to crush, stamp, smelt, amalgamate, refine, and in all ways treat, prepare for market and utilize and sell the same. . . .
>
> To manufacture, process, purchase, sell and generally trade and deal in and with goods, wares and merchandise of every kind, nature and description, and to engage and participate in any mercantile, industrial or trading business of any kind or character whatsoever.
>
> To such extent as a corporation organized under the General Corporation Law of the State of Delaware may now or hereafter lawfully do. . . . all and everything necessary, suitable, convenient or proper for. . . . to promote the interest of the corporation or to enhance the value of its properties. . . .

Also, to avoid any possible preclusion of corporate rights, there is a general close-out clause which states that "The foregoing enumeration of specific purposes and powers shall not be held to limit or restrict in any manner the purposes and powers of the corporation. . . ."

To the layman, it would seem that the concluding, empowering clauses recited above would be sufficient, alone, to give corporations the right to engage in almost any kind of business whatsoever. Yet the lawyer

[26] See dockets of the Securities and Exchange Commission for charters of this company and the other two that are cited in this section.

deems it essential to avoid doubt and to rely upon positive declaration rather than upon inference or assumed privilege; consequently, the powers are stated in as much detail as possible. Often, many of the objects are a repetition of rights granted by law and, therefore, would be allowed without specific mention in the articles. Inclusion of these stipulations, however, is not entirely redundant but helps to make the corporation's objectives more complete and precise.

IMPLIED RIGHTS

The corporation is deemed to have certain rights which may not be expressly stated in either its articles of incorporation or general corporation law. Such rights are those that are incidental to the operation of any business, whether it be organized in the corporate form or in any other way. Included among the many available examples of these rights are the right to buy and sell, the right to hire and discharge employees, and many other similar rights necessary to the operation of a business enterprise. However, it should be noted that many of the implied or natural rights of business operation are not necessarily free of restraint of one type or another. For example, there is the familiar review of advertising and sale practices by the Federal Trade Commission; again, many products of the food and drug variety are subject to the special requirements of pure food laws. Even the right to engage and dispense with the services of labor must be in conformity with laws prescribing minimum or fair labor standards and, of course, must often comply with restrictions arising out of labor union contracts.

ULTRA VIRES ACTS

Those acts that are committed by a corporation outside of the scope of its authority are said to be *ultra vires*. While an act of this type is unauthorized, it need not be illegal. The status of such transactions depends upon the pertinent circumstances as well as upon the intent of the parties. If the act is within the reasonable scope of the corporation's activities, the party involved will be able to enforce his claim against the corporation. On the other hand, if it is evident that the act is far removed from the scope of the corporation's normal activity and beyond the expectation of a reasonably prudent person, then any contract arising out of the *ultra vires* act could not be enforced against the corporation. If the situation arising out of an *ultra vires* act has not yet been carried out; i.e., if the obligations imposed by the contract have not been fulfilled by either party, then either party may rescind the contract. However, when the contract has been executed by either party, the courts will ordinarily require proper payment by the other party.

The *ultra vires* principle may be applied to various aspects of cor-

porate life. For instance, if a corporation issues bonds in violation of its charter or bylaw provisions, the act is *ultra vires*. While the powers of a corporation generally include the right to issue bonds, it may preclude or limit their issuance by express reservation in either its charter or bylaws. Any violation would, of course, be exceptional but, if it occurred, the purchasers of the bonds would not be devoid of rights and the corporation would be liable to the bondholders for damages. On the other hand, if bonds were issued contrary to the statutes, the action would be illegal and the bonds would be void. In some states, for example, public utilities may not issue bonds in excess of outstanding stock; and if a company should violate this requirement, the bonds would be illegal.

It is likely that *ultra vires* actions had much greater meaning in the early period of corporate development than is true at the present time. One authority has gone so far as to say that the broad purposes for which corporations may be organized may "abrogate or limit the operation of the doctrine of *ultra vires* action."[27] Obviously, the force and effect of this doctrine must be vitally affected by the nature of the grant of powers contained in the charter; and it undoubtedly has more applicability to the small than to the large corporation. Generally speaking, it has more significance today as to the "how" rather than as to the "what" of corporate activities.

WHICH STATE?

Having an important bearing upon the rights and powers of corporations, especially in our recent history, is the particular state in which the charter is issued. Quite naturally, there are important differences among the several states; and the question of where to incorporate is often as important as the decision to use this form of organization. It is true that a single state may set a pattern that is copied by others; but, even so, there exists the familiar range from conservatism to liberalism. One of the liberal states is Delaware, which, despite its small size, is highly favored by large corporations. Among some of the more important corporations receiving their charters from this state are those listed on page 47 with their dates of incorporation.

Some may be prone to criticize the state of Delaware for its leadership in the enlargement of corporate powers; others are equally vigorous in giving it credit for developing the first modern corporation law. Other states exceed Delaware as to the number of charters granted simply because they have a much larger volume of local and intrastate business. For example, in the year 1954, New York state issued some 25,591 charters and Illinois 5,502, as compared with 2,816 by Delaware.[28]

[27] W. B. Rutledge, Jr., "Significant Trends in Modern Corporation Statutes," *Washington University Law Quarterly*, Vol. XXII (April, 1937), p. 320.

[28] Dun & Bradstreet, Inc., *op. cit.*, p. 6.

In selecting a state for incorporation, there are obviously many features which have a bearing upon the decision. However, it is seldom advisable for a concern engaged chiefly in intrastate activities to obtain a charter outside of its home state. Other states may have more lenient and favorable laws of incorporation, as well as lower taxes; but these benefits are more than offset by numerous disadvantages. Unlike a natural person, a corporation does not have the right to do business within another state unless permission is granted by that state. Any organization which obtains its charter of existence from a state other than the one in which it operates is classed as a foreign corporation. Both the cost and the inconvenience of this status are sufficient to justify, in most cases, operation on a domestic basis, i.e., to warrant obtaining a charter in the state where the operations are located.

E. I. du Pont de Nemours and Company	1915
General Motors Corporation	1916
Radio Corporation of America	1919
General Foods Corporation	1922
Bethlehem Steel Corporation	1919
California Electric Power Company	1914
Tennessee Gas Transmission Company	1947

Where operations are primarily interstate, or where the activities of the corporation are spread over a number of states, the problem is entirely different. Under these circumstances, the state conferring the broadest powers at the lowest tax cost is the one to be favored. Most holding companies are among the corporations which find it desirable to choose a state allowing a wide range of powers. Where operations are both interstate and intrastate in character, it may be advantageous to incorporate on a large scale in one state and to set up a smaller corporation in each of the other states where operations are conducted. This pattern of organization takes form automatically, of course, when expansion is effected by the acquisition of stock of existing companies located in other states. Even here, a design or blueprint of anticipated growth is likely to cause the primary company to obtain its charter from a state with favorable laws. Not surprisingly many of the electronic and other companies with technological interests are chartered by the state of Delaware; for the sake of example, we may mention: Litton Industries, Incorporated; Texas Instruments, Incorporated; and Thiokol Chemical Corporation.

ATTEMPTS TO DEVELOP UNIFORM STATE LAWS

The development of corporation laws has been largely a product of competition among the various states. Whatever the reason, whether it be the search for additional revenue or the pressure of private interests, states have vied with each other to meet business demands. The variety of laws resulting from this competition has led to some confusion and uncertainty regarding public policies in the treatment of corporations. Some

legal authorities are inclined to be optimistic enough to hope, if not believe, that eventually the various corporation laws will be standardized. A step in this direction was made by the National Conference of Commissioners on Uniform State Laws in 1933, when it drafted the Uniform Business Corporation Act, which was also approved by the American Bar Association. While this may prove to be a workable solution of the problem, some feel that the only real answer of substance is the federal chartering of all corporations engaged in interstate business.

FEDERAL INCORPORATION

Because neither the federal constitution nor most state constitutions contain the word "corporation," the chartering of corporations is mainly an implied right of government.[29] By its nature, the federal government would, of course, be limited in its activities to companies engaged in interstate business. The exercise of this authority has been rare, the Union Pacific and Northern Pacific railroads being examples of its use. Also, under its currency powers, the federal government charters national banks, federal savings and loan associations, and federal credit unions, which in most communities are engaged mainly in intrastate or local business.

To meet the problems of large corporations, some authorities believe that federal charters have much merit as a means of providing relief from the numerous and varied laws and practices now in vogue among the states. The question may well be raised as to why any state should have the right to authorize a corporation to conduct interstate business involving the other states of the Union. For example, why should the state of Wisconsin have the right to give the Chicago, Milwaukee, St. Paul & Pacific Railroad Company a charter to operate a railroad extending from the Middle West to the Pacific Coast? Broad powers and minimum restrictions which may be found in the charters granted by one state are necessarily beyond the control of the other states in which the foreign corporations may operate.

In the words of one authority, "the proposal of a national incorporation act is intriguing but has its difficulties . . . although . . . the proposal has real possibilities, and probably will turn out to be the ultimate resort of an impatient, if not angry, public."[30] The appeal of federal chartering is found in its establishment of a regulating authority that is commensurate with the scope of modern corporate activity. Thus far, however, positive plans to put such a program into effect have seldom progressed beyond the stage of discussion. At the same time, it is possible that the increasing interstate nature of business may slowly nurture the idea. A concrete example of proposed legislation that was directed to the

---

[29] Fletcher, *op. cit.*, pp. 418–19.

[30] Rutledge, *op. cit.*, p. 340.

basic objective was the O'Mahoney Bill[31] that provided for the licensing of corporations engaged in interstate commerce. According to its terms, corporations would obtain their charter from the various states, as is now the case; but before entering interstate commerce, they would have to obtain a federal license, which would be issued only if the corporation met certain prescribed conditions, and which could be revoked for certain breaches of conduct. In this way, higher standards and greater uniformity could be enforced upon corporations engaged in interstate commerce, which would account for the bulk of business activity, although by no means the majority of individual corporations.

TRENDS IN STATE AND FEDERAL POLICIES

Probably most important in the selection of a state for incorporation are the powers that are granted to corporations and the facilities for control. Public policy is caught on the horns of a dilemma—seeking to preserve the democracy of shareholders' rights and interests while attempting to facilitate the orderly and effective direction of corporate affairs. The issue is made all the more acute because of the broad grant of powers which is now a common feature of corporation statutes.

While the conflict of objectives makes it difficult to speak conclusively about the trend, there is considerable evidence that state laws are being molded to aid centralization of control. In this respect, they differ from federal enactments which, following the financial crisis of the early thirties, were developed on the theory that it is the duty of government to champion the cause of the stockholders. Appraising the change in state corporation laws over the past half century, one authority has said that the modern statutes are characterized "by the abandonment of any attempt to limit the size of corporations, by the willingness to allow incorporators a very large measure of freedom to determine the character and internal government of their organization, by the relaxation of earlier restrictions on the consideration for which stock may lawfully be issued, by the abandonment of any attempt to discourage the incurring of an indebtedness exceeding the amount of the capital, and by the insertion of a number of provisions designed to facilitate corporate growth and corporate change."[32]

In more specific terms, it may be observed that the voting rights of stockholders may lose much of their vitality under the laws of various states which permit the concentration of control in a single class of stock or the use of voting trusts giving exclusive voting rights to a few indi-

[31] Senate Bill 3072, 75th Cong., 2d sess., 1937, *Congressional Record*, pp. 494–98; J. C. O'Mahoney, "Federal Charters and Licenses for Corporations," *Journal of the National Education Association*, Vol. XXVII, No. 1 (January, 1938), p. 27.

[32] E. Merrick Dodd, Jr., "Statutory Developments in Business Corporation Law, 1886–1936," *Harvard Law Review*, Vol. L, No. 1 (November, 1936), p. 38.

viduals. Similarly, there is a tendency to eliminate the prior right of stockholders to buy new stock issues and to restrict their rights to obtain information. Conversely, increased powers are being given to the board of directors and its executive committee.[33] Quite naturally, management will give careful consideration to these features in its search for the "best" state for incorporation.

While there is little immediate prospect of avoiding the issuance of corporate charters on a routine basis, the question may be raised as to whether the pendulum of corporate freedom may not have swung too far. It should also be stressed that more than business issues are involved. The extension of the federal area of influence and control has been pronounced during the past three decades; and the preservation of the long-recognized right of the individual states to grant charters to business corporations, whether engaged in intrastate or interstate commerce, may be at stake. Many other related questions of democracy tie into the problem, since the manner and mode of business operation have pronounced influence upon our way of life.

With this broad background of the nature of the corporation, we may now sharpen our concept by analyzing some of the more technical aspects. In the next chapter, study will be made of the charter itself and the means employed to incorporate.

QUESTIONS AND PROBLEMS

1. Discuss "the view that associated rights and collective entity antedated individual rights and entity." Evaluate the significance of the difference between the informal or nonlegal entity of any recognized group and the legally recognized entity of the corporation.
2. In our early history, why was there fear of the continuity of existence of corporations? Do you favor or oppose the use of charters that provide limited life?
3. "The fact that the corporation receives its birthright from the state must mean that it has a continuing obligation to the public throughout its entire life." Explain and discuss.
4. Unlike proprietorships and partnerships, corporations use other people's money, particularly as they increase in size. (*a*) Do you think that this characteristic of corporations endows them with a public purpose? (*b*) Do you think that special measures are necessary to protect the public purpose? (*c*) Evaluate the nature and mutuality of private and public purpose.
5. Do you think that the grant of authority to the impersonal corporation necessitates sufficient public regulation to assure continuous representation of the public interest?
6. Why were corporations originally restricted to a "singleness of purpose" or to a limited and specified field of activity?
7. Because of the possible abuses of the corporate form there are occasions when it may be necessary to "pierce the corporate veil." One authority has

[33] Rutledge, *op. cit.*, pp. 326–34.

stated that "It is coming to be recognized as the policy of the law that shareholders should in good faith put at the risk of the business unincumbered capital reasonably adequate for its prospective liabilities. If the capital is illusory or trifling compared with the business to be done and the risks of loss, this is a ground for denying the separate entity privilege." (*Ballantine on Corporations* [rev. ed., 1946], pp. 302–3). (*a*) Evaluate the possibilities of abuse of the corporate form. (*b*) Should not creditors ordinarily be expected to exercise sufficient care and prudence to protect their own interests?

8. Discuss the franchise characteristics of a corporation.
9. Show how the present broad statement of purpose tends to nullify the meaning of *ultra vires* acts.
10. Refer to *Moody's Industrial Manual* and note the location of the plants of Litton Industries, Inc. and of Texas Instruments, Inc. Evaluate the reasons and justifications for a Delaware charter.
11. The state of Delaware has frequently been referred to as a "charter factory." Discuss the business and public-policy features of such a condition.
12. What are the arguments against federal incorporation? Do you favor federal registration of corporations engaged in interstate commerce?
13. In recent years, what conditions have developed that tend to curtail the freedom of the corporation?
14. Discuss with a local company its experience in complying with the federal law covering wage and hour conditions.

REFERENCES

Berle, Adolph A., Jr. *The Twentieth Century Capitalist Revolution.* New York: Harcourt, Brace & Co., 1954.

Buchanan, N. S. *The Economics of Corporate Enterprise,* chap. iii, secs. 1 and 2. New York: Henry Holt & Co., Inc., 1940.

Cadman, John W., Jr. *The Corporation in New Jersey Business and Politics.* Cambridge: Harvard University Press, 1949.

Dodd, E. Merrick, Jr. "Statutory Developments in Business Corporation Law, 1886–1936," *Harvard Law Review,* Vol. L, No. 1 (November, 1936), pp. 27–59.

Evans, G. Heberton, Jr. *Business Incorporations in the United States, 1800–1943.* New York: National Bureau of Economic Research, Inc., 1948.

Fletcher, William Meade. *Cyclopedia of the Law of Private Corporations,* Vol. 1. Rev. and permanent ed. Chicago: Callaghan & Co., 1931.

Rutledge, W. B., Jr. "Significant Trends in Modern Corporation Statutes," *Washington University Law Quarterly,* Vol. XXII (April, 1937), p. 317.

Stevens on Corporations, chap. iv. St. Paul: West Publishing Co., 1936.

Weissman, Rudolph L. *Small Business and Venture Capital,* chap. v. New York: Harper & Brothers, 1945.

Chapter 4 ►

THE CORPORATE CHARTER AND RELATED FEATURES

OTHER THAN for the special classes of corporations —public utilities, railroads, moneyed corporations, etc.— there are few restraints in starting a new corporation. Similarly, there is little direct public regulation of management. Some legislative acts, such as the labor, tax, and security laws, have completely changed the complexion of financial policy and management; but these are mostly a form of indirect control. Any group which organizes a corporation is aware of the effects before it starts and is presumed to have weighed them in the balance before enjoying the freedom of incorporating either a new or an existing enterprise. Actually, as discussed in the preceding chapter, the trend has been toward the loosening of governmental restraints on new charters.

THE STEPS IN INCORPORATION

Because of the standardization of the procedures and requirements for incorporation, it is possible for a layman to complete the task himself; but usually its basic legal nature makes it advisable to engage the services of a competent attorney. By so doing, benefit is derived from his experience; and there is less likelihood of making mistakes. The more important steps to be taken in the organization of a corporation, whether it be large or small, may be listed and discussed briefly: (1) preparation of the articles of incorporation, (2) petition to the state and payment of fees, (3) approval and filing, and (4) the organization meeting.

PREPARATION OF ARTICLES OF INCORPORATION

While the corporation is a creature of the state, its incorporators prepare their own articles of incorporation. Strictly speaking, the term "articles of incorporation" is more accurate than "charters," since the basic authorities of corporations are now found mainly in the general incorpo-

ration laws.[1] However, the latter expression is still commonly used because of both tradition and convenience and, for this reason, will be used here as being synonymous with "articles of incorporation."

The nature of the articles of incorporation may vary according to the type of business, but the following are common requirements: (1) the name of the corporation, (2) the location of the principal office, (3) the purpose or purposes, (4) the maximum of par or no-par shares which the corporation wishes authorization to issue, (5) the amount of capital required to begin business, and (6) provision for the form and valuation of the consideration for which shares are issued. Some of the more salient points which arise in connection with the foregoing articles may be mentioned briefly.

Name of the Corporation. The name of the corporation may appear to the layman to be inconsequential, but its selection may actually be cause for considerable discussion. To a certain extent, it becomes the quintessence of all that the business may represent. As an earmark for public reference, the name takes on meaning as the corporation becomes known for its products and policies. Many corporate names are worth millions of dollars because they represent a long accumulation of valuable good will or are peculiarly fitted to represent a particular type of business. An excellent illustration is offered by the magazine *Life*, which paid a large amount purely for the right to use the name when the publication previously bearing this title went out of business.

Even when companies expand their operations by adding new products either by mergers or by their own development, there is reluctance to change their names because of the attaching good-will value when corporations are well and favorably known. It should not be forgotten that fabulous amounts are spent for the express purpose of increasing public favor and identification—in some cases, emphasis being placed upon the more convenient nomenclature of euphonious initials. For example, the Radio Corporation of America is more commonly known as RCA; nor has it changed its name to reflect its manufacture of television sets and numerous other electronic products. Similarly, the General Motors Corporation, the General Electric Company and a host of others stress their sponsorship or connection with a product rather than impair the recognition of their long-standing names. As in personal life, much significance is attached to a good name.

The choice of a corporate name is more a matter of art than of science; but it is not uncommon to select a title that (1) reflects the sponsorship of the person promoting or operating the enterprise, (2) gives ready reference to the product or service, or (3) conveys meaning as to the location of the plant or area of activity. Whichever basis is used, it is usually desirable to give some indication of the nature of the business in

[1] William Meade Fletcher, *Cyclopedia of the Law of Private Corporations* (rev. and permanent ed.; Chicago: Callaghan & Co., 1931), Vol. 1, pp. 540–41.

which the corporation is engaged. Selected examples of the three categories will suffice to illustrate these features:

1. Personal emphasis—the Ford Motor Company; Sears, Roebuck & Company; Westinghouse Electric Corporation, etc.
2. Product emphasis—Sun Oil Company; Perfection Stove Company; Real Silk Hosiery Mills, Inc., etc.
3. Area emphasis—United States Steel Corporation; International Harvester Company; American Telephone and Telegraph Company, etc.

Legal requirements covering the choice of name are not specific but simply provide (1) that the name must not deceive the public in any way and (2) that it must be easily distinguished from the name of any other corporation authorized to do business in the state. New enterprises often attempt to adopt names that are similar to, or identical with, those of existing concerns in an effort to gain the benefit of reputations already established. This is seldom possible in the case of two companies operating in the same state, but a local concern may succeed in doing this where a national organization may not have facilities in a given state. For instance, the United . . . Company operating throughout most of the country did not have any units in Florida. Local promoters organized a United . . . Company of Florida, taking advantage of the prestige of the national group. Later, the larger company saw fit to pay a substantial price to buy out the local company.

Location of Principal Office. In most cases, the home or principal office is located at the site of operations; but large corporations, with their scattered activities, may select an area that is more convenient for purposes of central administration. It is also necessary for them to maintain an office in the state issuing the charter. Instead of setting up complete home-office facilities, it is not uncommon for a single individual or trust company to act as agent for many corporations. This agent will do little more than keep a duplicate list of stockholders and be authorized to accept or reply to legal processes served against the corporation.

Statement of Purpose. As stated in the preceding chapter,[2] it is now customary for corporations to provide for a wide range of powers in declaring their purpose. Once, the major requirement in the statement of the purpose of a corporation was to provide exactness of language so as to leave little doubt about the scope of operations; but, today, in addition to a well-defined objective, there is purposeful provision for as many powers as possible. Typical covering language consists of "any lawful purpose," "any lawful business," or "for any purpose or purposes, other than the carrying on the practice of any profession, for which natural persons lawfully may associate."[3] However, there is the expected exclusion of banking, insurance, public-utility, and other special forms of activity.

---

[2] Chapter 3, p. 44.

[3] W. B. Rutledge, Jr., "Significant Trends in Modern Corporation Statutes," *Washington University Law Quarterly*, Vol. XXII (April, 1937), p. 317.

Even though such broad powers would seem to need no refinement of detail, legal prudence calls for a reasonably specific statement of the objects of incorporation, to which the general authorization is appended. For instance, the clause authorizing merchandising may be stated "to buy, sell, exchange, trade and otherwise deal in any and all kinds of manufactured articles, raw materials, minerals, animal and plant products, etc."[4] From the corporate point of view, of course, a broad statement of authority lessens the need for amendment of the articles of incorporation and widens the base of operations. Speaking generally, it may be said that a central theme has been substituted for a narrow and specific purpose.

Amount of Capital. Minimum capital requirements are so low in all states that they exercise little influence in the selection of a state for purposes of incorporation. Seldom is the amount in excess of the $1,000 required in Illinois, Michigan, and other states; while $500 is fairly common, this being the minimum specified in such states as Ohio, Wisconsin, and Vermont. In a number of instances, no minimum amount of capital stock is stated; and, in a few others, it is provided that the authorized capital shall be specified by the charter.

The earlier provision for a maximum capital authorization is now obsolete, again suggesting that the statutes are drawn mainly for the purpose of convenience in creating a corporation. As a result, the corporate form is equally as available for limited personal interests as it is for the mobilization of diversified public representation. It is used for temporary ventures and family enterprises just as it is for large organizations which engage in business on a national scale.

Similar liberalization is seen in the general absence of any limitation on the amount of indebtedness which corporations, other than public utilities or other special types, may incur. As far as the law is concerned, there are practically no restraints on the arrangement of the capital structure. Indeed, there are cases of corporations with capital stock of only $500 or $1,000 and with liabilities of $1,000,000 or more. It is apparent that the sponsoring interests assume little risk under such circumstances, but the opportunities for profit may be virtually unlimited. In short, legal capital requirements are only nominal in character and have little significance in shaping financial arrangements.

Probably the chief importance of the initial declaration of the amount and type of capital stock is its effect upon size and expansion. Unless the authorized capital is large enough to provide for future needs, it is necessary to amend the charter. This is not difficult to accomplish, but it does necessitate legal procedures in the form of calling a shareholders' meeting for its approval and making formal application to the state. Consequently, most corporations usually provide for an authorized capital which is in excess of the amount issued at the time of getting started.

---

[4] From the charter of the Atlas Corporation, as quoted in J. C. Baker and D. W. Malott, *Introduction to Corporation Finance* (New York: McGraw-Hill Book Co., Inc., 1936), pp. 13–14.

Consideration for Issuance of Shares. Most corporate statutes provide that shares may be issued only for adequate and equivalent consideration; i.e., that equivalent value will be received for the shares. In furtherance of this objective, shares of any one offering must also be sold at a uniform price. Otherwise, the measure of equivalent consideration would be destroyed; and favoritism of insiders would be facilitated. One of the chief difficulties encountered in determining the adequacy of consideration is found in the valuation of services rendered and of the worth of intangible assets which are given in payment of shares. Outside investors invariably pay cash for their stock, automatically precluding any dispute as to whether their stock was fully paid. On the other hand, promoters and other insiders usually receive at least a part of their stock for their personal services or for various property items other than cash. It is well known that values determined by personal appraisal lack the objectivity of those resulting from market operations.

Illustrative of the influence of appraised values upon the statement of corporate assets is the following case:

> . . . the balance sheet of a newly organized manufacturing company set forth its fixed assets at a valuation of approximately $700,000. The properties in question had recently been acquired at a cost of $200,000 and were appraised, on the basis of reproduction cost new less depreciation, at approximately $1,200,000. For balance sheet purposes the company placed an arbitrary valuation of $700,000 on the properties, thus creating a "surplus" of approximately $500,000. The Commission instituted stop-order proceedings on the grounds that the balance sheet representations were misleading and that, in this instance, reproduction cost less depreciation did not constitute a criterion of value since the issuer had not demonstrated successful use of the properties warranting such valuation. As a result of the proceedings, the issuer amended its balance sheet to show the properties at cost, $200,000, thereby eliminating "surplus" of one-half million dollars which appeared on the balance sheet as originally filed.[5]

As stated above, intangible property items, particularly, lack a stable basis for valuation. Showing the range of value concepts for this type of asset is the following case:

> A registration statement filed by a bottling company in connection with a proposed public offering of common stock contained a balance sheet of the issuer which included among its assets franchise rights at a stated valuation of $2,500,000. It appearing from information contained in the registration statement that the valuation ascribed to the franchise rights was excessive, the Commission proceeded to a hearing under Section 8 (e) of the Act. At this hearing, evidence was adduced to indicate that no basis existed for the valuation placed upon this intangible asset, whereupon stop-order proceedings were instituted under Section 8 (d) of the Act. Upon notice of hearing the registrants

---

[5] Securities and Exchange Commission, *Third Annual Report for the Fiscal Year Ended June 30, 1937* (Washington, D.C.: U.S. Government Printing Office), p. 5.

filed an amended balance sheet reducing the valuation of the franchise rights from $2,500,000 to $1.[6]

Further appreciation of the significance of issuing shares for equivalent consideration is found in a financial concept or condition which is pertinent throughout the operating life of a corporation. Reference is made to the disappearance of identity of specific funds once they become a part of the corporation. Whether they come from outsider or insider, from bonds or stock, from earnings or capital investment, all funds are merged into a common and over-all operation. As a result, expenses may in reality be paid out of capital funds; and dividends may, in various states, be paid out of surplus created by the issuance of shares at a premium. Such practices usually result in failure if continued long enough, but the important point here is the realization by the student of finance of their nature and meaning. As examples of these activities, the following two cases may be cited:

Case No. 1. A mining company seeking to register an issue of its common stock, was required to amend its prospectus to disclose that it had been selling stock to the public for more than 20 years and that only a small percentage of receipts from such sales had been used in actual development of the properties, the balance having been used principally to pay salesmen's commissions, office expenses, and salaries. The company . . . requested permission to withdraw its registration statement after a year's unsuccessful attempt to sell its securities by means of its amended prospectus.[7]

Case No. 2. A Delaware corporation filed a registration statement covering 15,000 shares of $1.50 convertible preferred stock (par value $5) and 52,750 shares of common stock ($1 par). Under the charter provisions the preferred stock was entitled in liquidation to $25 per share and was proposed to be offered at $27.50 per share to net the company $25, of which $5 was to be allocated to capital and $20 to paid-in surplus. Under the Delaware statutes, corporations may pay dividends on any class of stock out of paid-in surplus. The registration statement and prospectus did not disclose the possibility that thus, under the laws of Delaware, the common stock holders might receive dividends out of surplus contributed by the preferred stock holders, thereby taking away the surplus contributed by the preferred holders covering the excess of liquidating value over par value. Accordingly, the Commission required the registrant to include as a footnote to the preferred stock account in the balance sheet a statement of the aggregate amount to which the preferred stock would be entitled in liquidation, and an opinion of counsel for the company as to whether there was any legal restriction on surplus by reason of the fact that the amount to which preferred shareholders would be entitled in liquidation exceeded the par value of the stock. It was stated in the footnote that in the opinion of counsel there was no such restriction but that it was the present intention of the company to limit the payment of dividends to the amount of surplus in excess of $20 per share of preferred stock outstanding.

Since the effective date of the registration statement, the company has indi-

---

[6] *Ibid.*, pp. 4–5.

[7] Securities and Exchange Commission, *First Annual Report for the Fiscal Year Ended June 30, 1935* (Washington, D.C.: U.S. Government Printing Office), pp. 27–28.

cated its intention to remove from surplus and allocate to capital, by proper legal procedure, a sufficient amount of such surplus to cover the full liquidating value of the preferred stock.[8]

The reader will appreciate the fact that cases of this type are the exception, but this in no way minimizes their importance. Sound finance is built upon a foundation of public confidence which, unfortunately, suffers more damage from the few instances of malpractice than can be repaired by the vastly predominant honest and proper incorporations. Obviously, legislation can do little more than establish the broad principle that security issues must be covered by accompanying asset value. Effective enforcement must rest primarily with the courts that decide specific cases and with administrative agencies concerned with the regulation of securities. Particular attention will be given to the activity of the Securities and Exchange Commission in Chapters 20 and 21.

PAYMENT OF FEES AND PETITION TO THE STATE

Taxes, like any other important cost of doing business, also play a vital part in selecting the domicile of the corporation. Space prohibits any exhaustive treatment of the subject, but it may be noted that corporations are generally subjected to two types of taxes by the different states. Both are of a franchise nature—one being levied at the time of granting the charter and the other annually. The initial tax is sometimes referred to as a privilege tax "to be" and the annual tax as a privilege tax "to do." Both need to be considered at the time of incorporation.

The taxes charged by the various states for granting charters to exist as a corporation vary widely. The degree of variation can be seen to best advantage by comparing the taxes that would be charged by several of the states for the incorporation of a company having 1,000,000 shares of no-par common stock. Only the organization tax is included in the comparison below, and the miscellaneous filing fees and discretionary charges which usually accompany incorporation are omitted. The organization tax for the assumed corporation in four states as of 1960 would be as follows:

Delaware	$ 2,550
Ohio	5,100
Massachusetts	10,000
New York	50,000

The difference between Delaware and New York is striking and, assuming that other factors are equally favorable, would constitute adequate reason for choosing Delaware over New York as the state for incorporating. Also, those states which have the lowest fees generally have broad or favorable laws for incorporation.

---

[8] Securities and Exchange Commission, *Fourth Annual Report for the Fiscal Year Ended June 30, 1938* (Washington, D.C.: U.S. Government Printing Office), pp. 39–40.

It is more difficult to compare the annual tax levied on corporations because, in many instances, the tax is based upon a variable figure such as the volume of business done in the particular state, the value of property, gross income, or some other measure. For example, in New York, the tax is 4½ per cent of the net income derived from assets located in that state. This means that if a corporation earned 8 per cent on an investment of $100,000,000 in New York, its net income would be $8,000,000; and, therefore, its annual tax would be $360,000.[9] In contrast, if the enterprise were incorporated and doing the same volume of business in Delaware, the annual tax would be $2,777.50.

In Ohio, the annual tax is based upon a combination of the value of the property and the volume of business. The first step in determining the tax is to arrive at the value of the outstanding stock, as measured by the total of the company's capital, surplus, undivided profits, and reserve accounts, excluding reasonable reserves for depreciation, depletion, and taxes applicable to the year of the report. Good will may be excluded if it has been treated as an asset, as well as any additional amount by which the book value may be in excess of par value, provided proof of such existence can be made to the tax commission's satisfaction. The resulting figure is divided into two equal parts. One part is multiplied by a fraction, the numerator of which is the value of the corporation's property in Ohio and the denominator of which is the total value of all the corporation's property. The other is multiplied by a fraction whose numerator is the volume of business done by the corporation in the state and whose denominator is the total volume of business done by the corporation for the year of the report. The two results are added and subjected to a tax of three-tenths of one per cent. This method applies to both foreign and domestic corporations.

After the articles of incorporation have been drawn, they are filed with the proper state authorities, together with the required fees. The initial incorporation or filing fee is based upon the amount of authorized capital, measured either in dollars or in number of shares. Illustrative of the manner of computing the costs of incorporating that were previously mentioned are those levied by the state of Ohio, which are as follows:

Number of Shares	*Price for Each Share Authorized*
1–1,000	$0.10
1,001–10,000	0.05
10,001–50,000	0.02
50,001–100,000	0.01
100,001–500,000	0.005
500,001 and over	0.0025

The minimum fee is $25.

[9] Actually, the tax may be more than this amount, since three alternative methods of computing the tax are provided and the corporation is required to pay "whichever is greatest." In addition, there is a tax on the "subsidiary capital allocated within the state." See *New York Tax Laws*, sec. 210.

APPROVAL AND FILING

Much more than being a legal body or entity, the corporation also carries with it many valuable rights which are in the nature of a franchise.[10] Yet its creation is more or less automatic in most states, assuming, of course, that there is compliance with the legal requirements for organization. The state of Iowa is illustrative of states which still require a measure of supervisory review and the exercise of administrative judgment in passing upon the granting of a charter. The degree of discretion may be noted in the following language of the Iowa law:

> When articles of incorporation are presented to the secretary of state for the purpose of being filed, if he is satisfied that they are in proper form to meet the requirements of law, that their object is a lawful one and not against public policy, that their plan for doing business, if any be provided for, is honest and lawful, he shall file them; but if he is of the opinion that they are not in proper form to meet the requirements of the law, or that their object is an unlawful one, or against public policy, or that their plan for doing business is dishonest or unlawful, he shall refuse to file them.[11]

Aside from this exceptional instance, the corporation is now largely a form of expected right and is no longer a special privilege. Illustrative of this condition is the following statutory provision for incorporation in the state of Delaware:

> Any number of persons, not less than three, may establish a corporation for the transaction of any lawful business, or to promote or conduct any legitimate objects or purposes under the provisions of and subject to the requirements of this chapter, excepting for such purposes as are excluded from the operation of the general law by section 1, of Article IX, of the Constitution of this State, upon making and filing a certificate of incorporation in writing.[12]

As far as the general procedure is concerned, a copy of the articles of incorporation is usually certified by the state official (usually the secretary of state) and sent to the incorporators as evidence of their acceptance. The certified articles then constitute the new corporation's charter. In many states, it is also necessary to file a certified copy of the articles with the clerk or recorder of the county in which the corporation is located.

ORGANIZATION MEETING

Upon official acceptance, the incorporators call a meeting of all stockholders to fulfill various legal requirements which are preliminary to actual operation. In particular, the following must be provided for:

[10] For discussion of the point as to whether the corporation itself is a franchise, see Fletcher, *op. cit.*, p. 16.

[11] Code of Iowa (1958), chap. 491, sec. 491.6.

[12] Delaware Code Annotated (1953), chap. 8, sec. 101.

(1) election of directors and officers and (2) adoption of bylaws to govern corporate activities.

Election of Directors and Officers. One of the first requirements following incorporation is the election of a board of directors. Since at this point there is no wide distribution of stock, those who have acted in the capacity of trustees during the preliminary stages are usually elected. At ensuing annual meetings, the ultimate owners or stockholders are given an opportunity to express their choice. However, as has been noted elsewhere, the use of proxies and other devices makes it comparatively easy for the sponsors to retain their initial control.

The next step is the election of officers to have charge of the day-to-day operations. Such appointments are customarily made by the board of directors because election by the shareholders would be unwieldy as well as a source of possible friction. Corporation laws usually require as a minimum slate the following officers: president, secretary, and treasurer. In addition, the bylaws of the corporation may provide for such other officers as the following: chairman of the board of directors, various vice-presidents, assistant secretaries, assistant treasurers, etc. The exact number and type will depend for the most part on the size and nature of the business. Also, it is not unusual for a single individual to hold more than one office.

Bylaws. The major purpose of the bylaws is to provide regulations for the internal activities of the corporation. Third parties are not held for knowledge of these rules, since the bylaws are intended for the guidance of the directors, as well as to outline the routine necessary for the conduct of a corporation. The General Corporation Act of the state of Ohio lists the following items which may be included:

1. Provision for calling and conducting annual or special meetings.
2. Place of holding shareholders' meetings.
3. Requirements for a quorum for shareholders' meetings.
4. Means of determining stockholders entitled to vote.
5. Provision for the number and qualifications of directors, as well as a statement of their duties.
6. Stipulations governing directors, such as the place or places of holding meetings, requirements for a quorum, appointment of executive or other committees of the board, etc.
7. Provision for the sale or transfer of shares.
8. Any other statement of limitation or definition applicable to the scope of the corporation's activity, or of the directors' or shareholders' powers.

In short, the bylaws are a means of liaison between the shareholders and the directors; in contrast, the charter or articles of incorporation provide for the dealings of the corporation with third parties.

REQUIREMENTS FOR INCORPORATORS

The requirements specified for incorporators relate primarily to the following: (1) minimum number, (2) residence, and (3) other qualifica-

tions. In most states, at least three incorporators are necessary. This is true of Delaware, New York, New Jersey, Virginia, Maine, Massachusetts, Minnesota, and California, among others.

Many states have no residence qualifications for incorporators, but others require that at least one must be from the state of incorporation. New York provides that at least one must be from the state, and two-thirds of the group must be residents of the United States. In Ohio, it is stipulated that the majority of incorporators must be citizens of the United States; but no residence requirement is enforced. Aside from these features, the other general requirement is that the incorporators shall be natural persons; an exception to this rule is found in the state of Michigan. It should be mentioned that, as a matter of law, corporations also may not ordinarily become members in a partnership.

Mention may be made of the point that the authorization to create a corporation relates specifically and directly to the named incorporators. The right of transferability which attaches to the stock is not applicable to the roles played by the incorporators. "A charter granted or offered by the legislature must be accepted, if at all, according to its terms, and it can be accepted only by those persons to whom it is granted. When a statute, therefore, authorizes certain persons to organize themselves into a corporation, other persons cannot take their place."[13] However, once the corporation is completed as a recognized entity, there may be a sale of the charter. Such cases are not frequent but may be found, particularly when an existing corporation has ceased to operate as a going concern but has not yet formally canceled its charter. Under these conditions, the basis for negotiation is the charter itself rather than the stock. Also, in the creation of new corporations, the use of so-called "dummy" incorporators is not uncommon.

QUALIFICATIONS FOR DIRECTORS

The requirements for qualification as directors are similar in many respects to those for incorporators and have much the same variety of treatment. The usual requisite is that there shall be three or more directors, without any restrictions as to residence.

Some states require that the directors must be stockholders in the corporation, presumably to stimulate greater personal interest in the company's welfare. As explained in a later chapter, there is much to be said for linking ownership and control; but, customarily, most states make no requirement as to the amount of stock that the directors must hold, thereby permitting qualification through the ownership of as little as one share. Frequently, in the case of a subsidiary corporation, this qualifying share may be furnished to the director without cost, with the understanding that it will be returned in the event the director resigns or is

[13] Fletcher, *op. cit.*, p. 280.

replaced. New Jersey has an interesting variation of the stock-ownership requirement for directors. This state permits the election of a director who does not own stock, provided he does own stock in a corporation holding 25 per cent or more of the stock of the subsidiary corporation. By this means, any stockholder in a holding company is eligible to serve as director in any of the subsidiaries.

Speaking generally with respect to the qualifications of directors, it may be said that the most usual arrangement appears to be statutory declaration that the bylaws of a corporation shall specify the qualifications for directors. Some state laws—for example, those of Delaware, Nebraska, and Minnesota—provide that the directors need not be stockholders, but this would not preclude the adoption of a covering provision in the bylaws. Indeed, in California, the corporation code formally provides that the first directors need not be holders of stock, and further exempts succeeding directors unless the articles of incorporation or bylaws impose such a requirement. A variation is that directors must be stockholders unless otherwise provided for in the bylaws and charter.

LIABILITIES OF DIRECTORS

Most corporation laws include a statement of the liabilities of directors. The purpose of formally giving expression to them is perhaps twofold. In the first place, formal statement serves to remind the director of his obligations; and, second, it gives recognition to the importance of the articles of incorporation. In effect, the latter may be said to be the "constitution" of a corporation which, basically, represents an agreement or contract between the corporation and its representative officials as to the powers which may be exercised. We may first note the specific obligations imposed upon the latter, following which we may recognize those of a more general nature. In one state (Ohio), the statute sets forth such definite liabilities as the following:

1. If any corporation begins business before the capital specified in the articles of incorporation has been paid in, the directors participating in the act are jointly and severally liable for the debts of the corporation up to the amount of capital so stated. It should be understood that this does not relate to the authorized capital but only to the capital that must be paid in prior to the commencement of operations.
2. Officers, employees, and others are liable for issuing fraudulent reports.
3. If a loan advance is made to a director other than in the course of doing business, each officer approving the transaction is liable for the amount, plus interest at 6 per cent.
4. Directors are also liable for dividends paid contrary to law, which usually means paying dividends out of capital instead of earnings.
5. If there is distribution of assets during liquidation, the responsible parties are liable if there is failure to provide for known obligations having priority of claim.

Directors' liabilities vary from state to state, not only because of differences in the statutes, but also because of varied interpretations by the state courts. Until recent years, courts have been extremely reluctant to hold directors for acts other than extreme negligence and fraud. This philosophy resulted, at least in part, from the charitable conception that directors served without compensation and should not be held too rigidly for an accounting. Today, the interpretation varies from the strict criterion that they should be held responsible for the care that a reasonably prudent man would give to his own property to the more flexible view that they should be held only for action of a reasonably prudent director. Some people take the position that the element of trust requires that a reasonably prudent director give a greater degree of care to the property entrusted to him than if it were his own. Another group would tend to forgive the director for anything except the worst blunders in judgment. However, the former view is becoming more general; and the director is being treated as a fiduciary, with his actions being judged accordingly.

Illustrative of these principles, directors have been held for the following: (1) negligence in failing to attend meetings, (2) failure to inform associates of important information, (3) complacent acceptance of fraudulent action of officers, (4) allowing inefficient officers to remain in office, (5) failure to require a bond from an officer who later absconds, (6) actions without authority, and (7) acceptance of secret profits arising by virtue of their position.[14] Directors are not held for mistakes of judgment when reasonable investigation and study have preceded the decisions.

LIABILITY OF STOCKHOLDERS

The liability of the individual stockholders is limited to the initial purchase price in the case of no-par stock and to the stated value in the case of par stock. This means that, in the event of failure, the shareholder is liable for any difference which may exist between the purchase price or par value and the amount actually paid to the corporation. A few states, such as New York and Massachusetts, provide that stockholders shall also be liable for any debts to employees.

As late as 1931, the laws of California were more rigid in attaching liability to stockholders. In that state, it was specified that stockholders were liable for their proportionate share of the debts and liabilities of the corporation. To prevent the evasion of this law by incorporation in other states, it was stipulated that shareholders of foreign corporations doing business in California had a similar liability. Generalized observations about the liability of stockholders is not practical because of the variance

[14] Securities and Exchange Commission, "Committees and Conflicts of Interest," *Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees*, Part II (Washington, D.C.: U.S. Government Printing Office, 1937), pp. 22–31.

of state laws. To illustrate the point, we may note the provisions of the Nebraska statute dealing with the reduction of capital. Publication of such action is required, and failure to do so may make the directors liable for losses suffered by third parties and the stockholders liable to the extent that any payments are received as a result of the capital reduction.

SCOPE OF AUTHORITY OF CORPORATION

In viewing the many attributes of a corporation as a whole, it becomes clear that its intangible nature is given substance and reality mainly by the force of legal sanction. One writer goes so far as to say that "the modern corporation is the product of arbitrary legislation struck off at a given time. It does not represent the natural growth of the corporate idea, but rather is a distorted application of that idea."[15] Its authority to act, while broad in nature both as a result of liberal corporation statutes and as a result of implied rights, is vitally dependent upon enabling legal recognition. "If any general rule can be laid down, in the present state of authority, it is that a corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons."[16]

The present flexibility of the corporate form and its marked ability to raise large sums of capital impose upon financial management a high degree of economic responsibility. In terms of aggregate values, corporations dominate our business economy; and there are numerous individual companies which operate on a nationwide scale. Because of this importance, it is not surprising that the pressures of the prolonged depression of the thirties, the exigencies of war in the forties, and the ensuing concepts of perennial economic expansion brought about a deepening of public thought with respect to the obligations of corporations and private enterprise generally. In the long run, their degree of authority to act will be determined by the manner in which the accompanying responsibility is discharged.

QUESTIONS AND PROBLEMS

1. Discuss the reasons for exercising more restraint in the issuance of charters to moneyed corporations (such as banks) than to ordinary corporations.
2. Draft proposed articles of incorporation for an enterprise of your own choosing.
3. Discuss and evaluate the importance of selecting a suitable corporate name.
4. The well-known Radio Corporation of America is now operating in the

---

[15] Robert L. Raymond, "The Genesis of the Corporation," *Harvard Law Review*, Vol. XIX, No. 5 (March, 1906), p. 364.

[16] Fletcher, *op. cit.*, pp. 135–36.

general field of electronics. Discuss the arguments for and against a change in its name in order to reflect the full scope of its activities.

5. Do you think there is any merit in having a minimum capital requirement of $500 or $1,000?
6. Summarize the arguments for and against a maximum capital requirement.
7. What is the purpose of filing articles of incorporation at public offices?
8. Why do the states require foreign corporations to appoint agents?
9. What are the reasons favoring a residence requirement for incorporators?
10. "Normally the corporators are natural persons, but exceptionally may be corporations or other artificial ones." (William Meade Fletcher, *Cyclopedia of the Law of Private Corporations* [rev. and permanent ed.; Chicago: Callaghan & Co., 1931], Vol. I, p. 279). Discuss the problems of corporations or other artificial persons serving as incorporators.
11. Discuss the problems in determining whether "equivalent consideration" is received in exchange for shares.
12. In recent years, companies promoted for the purpose of discovering and mining uranium have been organized in large number. Frequently, more than 25 per cent of the initial capital proceeds are used to pay the commissions of financing agents and obviously cannot be put to corporate use. Do you believe that such a condition may be the cause of indirectly creating a lack of "equivalent consideration"?
13. Discuss the influence of taxes upon the selection of a state for purposes of incorporation. Also, discuss the merits of income taxes on corporations levied by both state and federal governments.
14. Why are bylaws necessary for the operation of a corporation? Distinguish between bylaws and the policies of operation.
15. Discuss the personal liabilities of corporate directors. Do you think that absence from meetings should excuse a director from liability?

REFERENCES

BERLOCK, H. "Federal Incorporation and Securities Regulation," *Harvard Law Review*, Vol. XLIX, No. 3 (January, 1936), pp. 396–425.

BUCHANAN, N. S. *The Economics of Corporate Enterprise*, chap. iii, sec. 3, and chap. iv, secs. 1 and 2. New York: Henry Holt & Co., Inc., 1940.

DODD, E. MERRICK, JR. "Statutory Developments in Business Corporation Law, 1886–1936," *Harvard Law Review*, Vol. L, No. 1 (November, 1936), pp. 27–59.

FLETCHER, WILLIAM MEADE. *Cyclopedia of the Law of Private Corporations*, Vol. 1. Rev. and permanent ed. Chicago: Callaghan & Co., 1931.

HARING, H. A. *Corporations Doing Business in Other States.* New York: The Ronald Press Co., 1927.

RUTLEDGE, W. B., JR. "Significant Trends in Modern Corporation Statutes," *Washington University Law Quarterly*, Vol. XXII (April, 1937), p. 317.

Stevens on Corporations, chap. xxiii. St. Paul: West Publishing Co., 1936.

PART II ►

Instruments of Corporation Finance

Chapter 5 ►

COMMON STOCK

TURNING FROM the organization of corporations, we may now begin our analysis of their financial structure. Both to get started and to meet the needs of later expansion, it is necessary to raise funds. After the establishment of successful operations, a considerable amount of capital may be obtained from the reinvestment of earnings; but, obviously, this source is not applicable to the initial demand for funds, or to major expansion programs that require immediate financing. These latter needs may be met only by the use of securities, which, as described earlier, may be of various types. The policies relating to the choice and issuance of securities will be reserved for later discussion; and, at this time, attention is directed mainly to their basic characteristics. It is appropriate to begin with the security that may be generally regarded as the cornerstone of the financial structure—common stock.

Unlike other securities which are utilized primarily as a means of raising capital, common stock has special and additional significance because of its rights of residual ownership of the corporation. Preferred stock, which is discussed in the succeeding chapter, creates a form of ownership; but it is limited and not final or residual.[1] Irrespective of the amount of common stock which may be outstanding, it usually is the nucleus of control and carries with it the familiar range of benefits and responsibilities which are ordinarily associated with ownership. It is the first security to be issued by a corporation and the last to be retired in the event of liquidation. The extremes of success or failure are the lot of common stock. ~~In the~~ case of unusual profits, it may be the beneficiary of extra or increased dividends; and, in the case of failure, it may suffer heavy loss. In short, as stated previously, common stock occupies a primary and residual position.

THE STOCK CERTIFICATE

When stock is sold either by the corporation or by transfer in trading, certificates are issued as evidence of the ownership rights. These certifi-

[1] The Great Northern Railway Company had no common stock in name until 1954, when the former 6 per cent noncumulative preferred stock was reclassified into no-par common, and the shares were split 2 for 1.

cates indicate that the holder is the owner of a certain portion of the corporate net worth. Actually, the certificate is stated in terms of shares, the share being the unit of measurement and the certificate simply stating the right to the number of shares purchased. The relationship may be illustrated by reference to our monetary system. A ten-dollar bill is the equivalent of 10 one-dollar units; but, for the sake of convenience, the right is expressed on one piece of paper. In the same way, a stock certificate for 50 shares of stock permits the combining of various shares into one larger unit.

COMMON STOCK—SUCCESSFUL OPERATION

To appreciate the residual character of common stock, we may first observe its position in a case where the operating results have been eminently successful. Outstanding in this respect is the General Motors Corporation, as may be seen in a comparative financial statement (Table 2) for the years 1959 and 1916, the latter being the year in which the charter was granted.

TABLE 2

Comparative Financial Statement of General Motors Corporation

	December 31, 1959	*July 31, 1916*
Current assets	$3,704,835,854	$53,492,558
Deferred charges	57,951,525	389,630
Other assets	582,633,579	8,292,626
Fixed assets (plant and intangibles)	2,900,987,069	18,722,205
Total Assets	$7,246,408,027	$80,897,019
Current liabilities	$1,138,678,579	$10,217,517
Debentures	252,296,000	—
Minority interest	2,392,265	1,228,458
Sundry liabilities and reserves	482,029,865	958,464
Preferred stock	283,564,400	14,985,200
Common stock	472,289,542	16,511,783
Surplus	4,615,157,376*	36,995,597
Total Liabilities	$7,246,408,027	$80,897,019

* Consisting of capital surplus of $553,273,244, and earned surplus of $4,061,884,132.

Since the common stock is entitled to all that is left after allowance for claims having priority, its book value increased from $53,507,380 in 1916 to $5,087,446,918 in 1959. As is clearly evident in Table 2, the increase is mainly the result of retained earnings. The book equity of the common stock does not generally measure its real value, which, for a going concern, is best determined by its worth in the market. In the case of the General Motors Corporation, based upon the average of the high and low price for the year 1959, the common stock had a market value of approximately $14,700,000,000.

Because of the phenomenal increase in the common stock equity from

1916 to 1959, the progress may be more readily appreciated by noting the changes during shorter periods. From 1916 to 1925, the book value increased from $53,507,380 to $377,100,423, or 605 per cent; from $705,188,777 in 1932 to $1,144,115,825 in 1946, or 62 per cent; and finally, in the ensuing period ended 1959, there was an increase to $5,087,446,918, or 345 per cent.[2] Moreover, in addition to the increase in the capital account, regular and extra cash dividends were paid on the common stock in the amount of $8,224,955,060 from 1917 to 1959. It should be said that this record is most exceptional, but it does illustrate in a dramatic manner the favorable position of the residual equity under conditions of successful operation.

COMMON STOCK—UNSUCCESSFUL OPERATION

To take another company from the same field of industry, the case of Willys-Overland illustrates the serious and opposite effects of unsuccessful operation upon common stock. This company was larger at one time

TABLE 3

Comparative Financial Statement of Willys-Overland Company

	March 31, 1937	*December 31, 1916*
Current assets	$ 6,169,520	$ 56,215,861
Deferred charges	330,773	381,279
Other assets	73,999	3,673,921
Fixed assets (plant and intangibles)	11,048,627	42,838,945
Total Assets	$17,622,919	$103,110,006
Current liabilities	$ 2,960,858	$ 19,387,478
Sundry liabilities and reserves	404,925	3,852,090
Preferred stock	3,207,990	15,000,000
Common stock	2,046,187	37,273,844
Surplus	9,002,959*	27,596,594
Total Liabilities	$17,622,919	$103,110,006

* Consists of capital surplus of $8,938,881 and earned surplus of $64,078.

than the General Motors Corporation, but failure resulted in its reorganization in 1936. The losses were so severe that the common stock was completely wiped out, the stockholders receiving only rights to subscribe to stock in the newly reorganized company. To reflect the changes that took place, we may note a comparative financial statement (Table 3) for a date shortly after reorganization and for 1916, when the present General Motors Corporation was chartered. Since the reorganization of the Willys-Overland Company previously indicated, its record has been erratic, and it was finally purchased in 1953 by the Kaiser Motor Corporation. Operating as a subsidiary of the latter under the name of Willys

[2] New capital subscriptions accounted for a small part of the increase. In early 1955, common stockholders were given the right to subscribe to 4,380,683 additional shares at $75 per share, on the basis of 1 share for each 20 shares held; other such offerings were made available in 1919 and 1920.

Motors, Inc., its financial statement revealed a deficit of about $14,500,000 at the close of 1954; currently, its stock is wholly owned by Kaiser Industries Corporation, and its separate financial condition is not reported.

COMMON STOCK AND ECONOMIC CONDITIONS

The difference in operating results between the General Motors Corporation and Willys-Overland reflects mainly the caliber of management, since both were subject to the same economic conditions. Particularly do adverse movements of the latter put management to the test; and the results are manifested in the market action of the common stock because of its residual position. In many ways, the aggregate stock equity functions like a shock absorber responding to the various pressures brought to bear on the corporation.

Not surprisingly, the public reacts to the ups and downs of corporate performance and is well known for its moods. In the garish twenties, common stock was in great demand and reached a peak in 1929, when some $5,112,000,000 of new capital was raised by this medium. The ensuing depression of the thirties generated the opposite response; in 1932, sales of new common stock shrank to an insignificant $13,000,000. Indeed, total sales of new common stock in the next decade amounted to less than half as much as was sold in the year 1929 alone.

During the war period of the early forties, the economy was naturally regulated to give priority to military needs, and government, itself, provided a large amount of capital and largely controlled the sale of new security issues of all types. Since that time, we have experienced an extended period of marked expansion, and common stock has gained new favor. Not only is it regarded as a popular offset against the familiar effects of inflation but, in addition, it is accorded special recognition as a means of participating in the growth of the economy. In this atmosphere, attention is attracted especially to stocks being issued by companies engaged in electronics, missiles, scientific research and development, and a variety of activities that are geared to meet the needs of the Space Age.

Examples of Stock Price Movements. Responding to general economic conditions and to the opportunities offered by industries with growth potential, stock prices display many erratic tendencies. The stock of Bethlehem Steel Corporation sold at a high of 140¾ in 1929 and declined to a low of 2⅞ in 1932; comparable figures for the stock of the well-known General Electric Company are 100¾ and 8½, respectively. Both stocks have since responded to the improved economic climate and have reached prices well in excess of their 1929 highs.

Currently, great emphasis is being placed on industry potential, and particularly when it is related to electronics and missile production. Even the mere mention of such relationships may generate fantastic speculative response. When the Bulova Watch Company announced the pros-

pect of an electronic watch, its stock advanced 3⅛ points to 21¾ on August 10, 1960. Again, a statement by the Lionel Corporation (commonly known for its toy trains) that it had named a former army missile chief as its president caused its stock to rise some 11¼ points in less than a week (reaching a new high of 34¼ in August, 1960).

Speculative responses of the type mentioned do not, of course, have a direct effect upon the financial status of a corporation, but they do create an atmosphere which may indirectly affect policy as well as the raising of new capital. For this reason, we may next establish an understanding of the basic concepts of stock valuation.

ANALYSIS OF STOCK-VALUE CONCEPTS

Although the word "value" has broad, everyday use, it has a wide range of meaning. Its subjective interpretations infiltrate into the area of its objective expression so that even the latter may not be universally defined. This is particularly true as it applies to stocks. Investors have a tendency to think that they may be purchasing stocks for less than they are really worth; and professional dealers in securities use the same idea for sales appeal. Conversely, the feeling may exist that stocks are selling for more than their worth. In either event, there is suggested the concept of a basic or intrinsic value. The underlying thought of a static or moving norm has interesting and provocative facets; but, at the same time, it is not subject to exact measurement. For our purposes here, we need simply mention this concept of normal value and confine our analysis to more concrete expressions of value—par value, book value, and market value.

Par Value. Prior to 1912, all stock certificates carried a nominal value per share, $100 being commonly used. If a corporation were capitalized at $50,000, it probably meant that 500 shares of stock at $100 par were available for distribution. Moreover, in many states, the laws did not permit corporate offerings to be sold at less than the par figure; i.e., they could not sell at a discount. When such was the case, there was a tendency for the par value to be the equivalent of the actual worth of the stock at the time of beginning corporate activity, unless, of course, the stock sold at a premium.

This potential agreement of par value with exchange value would naturally exist only momentarily. Business is dynamic in character, and values are changing constantly in response to the gains and losses accruing to the business enterprise. Large and increasing profits tend to increase the value of common stock; and, similarly, operating losses and other shrinkage of values produce an unfavorable effect. Since par value is a constant figure, it must necessarily fail to register or reflect changing conditions.

Book Value. As suggested by the term itself, the book value of common stock is its worth as shown by the accounting records. To visualize book value in its practical setting, reference may be made to the balance

sheet of the Gulf Oil Corporation (Table 4). The net worth or total book value of the common stock in this instance consists of the stock and two surplus accounts, or $2,631,509,076. To determine the more commonly reported book value per share, this amount is simply divided by the 100,129,192 shares outstanding—the result being a book value per share of $26.28. Stated in other terms, the book value of a share of common stock may be calculated by the following formula: assets less liabilities and other claims preceding the common stock divided by the number of shares outstanding equals the book value per share.

TABLE 4

SUMMARY CONSOLIDATED BALANCE SHEET GULF OIL CORPORATION
December 31, 1959

Current assets	$1,145,591,123
Plant, leases and equipment (net)	2,087,562,962
Prepaid and deferred charges	24,982,281
Other assets	318,181,582
Total Assets	$3,576,317,948
Current liabilities	$ 454,935,159
Long-term debt	265,934,596
Other liabilities	204,660,636
Reserves	19,278,481
Capital stock	834,334,933
Capital surplus	638,691,697
Earned surplus	1,158,482,446
Total Liabilities	$3,576,317,948

Since book value is based upon the results appearing in the accounting records, one may be inclined to believe that it represents the final or most realistic basis of valuation. Actually, it is a momentary or spot measurement, since the use of surplus to declare dividends or to absorb losses will bring about a corresponding change in the book value. Also, it is largely historical in character, giving convenient expression to the cumulative net results of the transactions recorded since the beginning of operations. For this reason, it seldom agrees with the market value, which reflects current investor opinion of the worth of the stock.

Market Value. Probably the most outstanding characteristic of a market is its realistic adjustment of prices in response to changing conditions, and it is not surprising that the market may not accept the value of the corporation as expressed in its books. The market value of stock for the successful corporation is often in excess of the book figure. Books of account ordinarily fail to record either possible or actual appreciation of values, and the market is dealing constantly in terms of the future outlook. It follows, too, that the unsuccessful corporation will ordinarily have a book value in excess of its market worth; and a similar relationship is not unusual for companies with a heavy fixed-plant investment. The cause of the latter is not the large capital *per se*. Rather, it is probable that the earnings lack the vigor to give buoyancy to the market;

and it is likely that there is some discounting of the nonfluid condition of the assets. Railroads give evidence of these characteristics in a pronounced manner, and steel companies often reflect their influence. For example, despite the high rate of production and earnings in 1954 of the well-known United States Steel Corporation, the market price of its stock ranged from 74½ to 39, while the book value at the close of the year was approximately $77.00. Since that time stock prices generally moved to higher levels with seeming minimization of the basic factors of value or performance. The prices of stocks of steel companies have responded in measure and, as a result, the price of the stock of the United States Steel Corporation is currently well in excess of the book value. Specifically, in 1959, the stock had a market range of 108⅞ to 88¼, while its book value at the close of the period was about $52.00.

Furthermore, a corporation may have a market value in excess of book value at a given time, only to have the condition reversed at another date. This may be caused by changes within the corporation itself, or by external conditions such as general business trends. Illustrative of the former is the record of the Chrysler Corporation. In earlier years its stock frequently sold at a price in excess of book value. However, in recent years its earnings have been erratic, to say the least. Net earnings in 1957 amounted to $119,952,406, following which there was a deficit in each of the two succeeding years. The book value of the stock amounted to about $77.00 per share at the close of 1959, as compared with a market high and low for the full year of 72⅝ and 50⅝; as of this time, the stock is selling at 38⅝. In contrast, the book value of the stock of the General Motors Corporation has consistently been less than its market price for an extended period of time.

The period from 1930 to 1932 illustrates dramatically the disturbing influence of adverse business trends. Few industries escaped the devastating effects of the business depression; and all automobile companies, without exception, reported declining sales. Stock prices tumbled in wild confusion and caused a marked change in the ratio of book to market value. During the late twenties, stock prices had increased with little regard to the book investment, causing market values to be greatly in excess of book figures. This was followed by a complete reversal, with irrational trading and dumping of securities in reckless abandon. The action of the common stock of the General Motors Corporation is typical of many others. In 1929, the stock reached a high of 91¾, which compared with a book value of $17.58; in 1932, the market quotation dropped to a low of 7½, while the book value was $14.27.

To comment briefly on the underlying factors that determine market value, it may be observed that it is basically the product of continuously changing internal corporate conditions and external economic influences. At times, the tempo of national and international problems may be of such dominating significance that important items of corporate develop-

ment may almost be ignored. At other periods, when there is an absence of external pressures, strictly corporate features may be dramatized beyond their real worth. Again, there may be intervals of comparative calm, or of lack of vigorous public and investment interest.

As to the market values of the individual stock issues, there is the familiar application of three well-recognized criteria of price—cost, comparison of values, and capitalization of earnings. The most convenient yardstick of the cost element is found in the book value which was previously discussed. Its acceptance by the market is continuously affected by the other two factors, since justification of the cost is constantly being tested by comparison with other securities and by the capitalization of the related earnings. Especially important are the current record and appraisal of the earnings outlook.

The relationship between the market price of a stock and the earnings is commonly reported as a "price-earnings" ratio. Prior to the early fifties, a ratio of 10 to 1 was widely accepted as a convenient rule of thumb. Today it is not unusual to find "20 times-earnings" used as a norm, probably reflecting the increased recognition accorded stocks as a medium of investment. In addition, as with most yardsticks of convenience, there is considerable deviation in pattern. Particularly may the so-called "growth" stocks show extreme departure and, similarly, stocks that are regarded as prime investments (termed "blue chips" in the market) may sell at much higher ratios than the average. For example, the price (438¼) of International Business Corporation stock at the close of 1959 was 55 times earnings for that year; for General Electric, 31 times.

General Observations. To make a summary statement about the various concepts of value, it is clear that none may be regarded as an absolute test. Rather, each serves a particular purpose and must be judged in that light. The following general observations are pertinent:

1. Par value is a nominal figure and does not reflect the amount that a stockholder may actually realize, either in the event of sale or in the case of liquidation of the company.

2. Book value registers the effects of transactions on a cost basis, but it cannot be accepted as a yardstick of true worth.

3. Market value is the most reliable yardstick of the amount that a stockholder may realize upon his investment, but distinction should be made between short- and long-term fluctuations in price.

LIABILITY ASPECTS OF PAR VALUE

Although par value has little meaning for purposes of valuation, its interpretation is more precise when applied to the calculation of the liability of stockholders. To illustrate, if stock having a par value of $100 were sold by the corporation at the time of original issue for $65, the stockholder would be liable for a possible $35 assessment, either if the corpora-

tion failed or if the corporation decided to expand and had need of extra funds. Since this liability is a feature of the stock issue, it is assumed by the new buyer in the event of later sale. Thus, if A had bought the stock from the corporation at $65 and later sold it to B for $110, B would assume the liability of $35 to the corporation.

Because investors would naturally avoid the purchase of securities subject to a potential liability, ways were early developed to circumvent or to avoid this contingency. In earlier years, when the par value was commonly $100, use was made of donated stock. Under this plan, the initial sale of stock is made to an individual friendly to the corporation or to an individual already having a large interest in the company. The stock may be paid for in cash, but services or other forms of property are the more likely means for payment because of greater leeway in their valuation. A piece of property worth $10,000 may be sold to the company for $25,000 in stock, with the understanding that the purchaser will donate $15,000 of this stock back to the company. Since the donated stock would be deemed to be paid in full, it would be legally nonassessable and could be sold to the public at any price which the company is able to obtain in keeping with market conditions. The use of this subterfuge entails the risk of stockholders' suits charging fraud or mismanagement and is a clumsy procedure in raising large amounts of capital.

NO-PAR STOCK

In the end, the only logical and reliable means of avoiding the liability attaching to par value was the issuance of stock without a stated amount, i.e., without any nominal value on its face.[3] This type of stock first became available with the enactment of a New York statute in 1912, and today it is permitted in every state. Considerable controversy arose as to the propriety of the no-par feature, with reformers taking the position that it should be made illegal. Proponents stressed the following advantages of no-par stock:

Avoidance of Contingent Liability. No-par stock may be sold at any price, and the liability does not extend beyond this initial figure. However, some states set a minimum price below which no-par stock may not be sold.

Increased Marketability of Stock Issues. Not only is the potential liability of further assessment avoided, but the corporation is enabled to sell the stock at any price. There is complete freedom for fixing a price that harmonizes with conditions prevailing in the market, rather than being limited by an arbitrary and rigid par established by a statute of many

[3] To distinguish between paid-in capital and accumulated earnings, it is not unusual to give no-par stock a stated value in the books. Unfortunately, the stated value may be changed by action of the board of directors; and, as a result, the permanent earmarking of paid-in capital is not assured.

years' standing. If there is a great demand for stock selling in the $60 bracket, such stock may be issued; or if stocks at a lower figure are more popular, then the price may be set to attract this demand. In general, no-par stock permits flexibility in the setting of price and gives relief from the more static requirements existing under laws requiring par stock.

Avoidance of Nominal Value. The use of no-par avoids any possible fiction of value resulting from the use of par. Investors frequently err in accepting par as a norm or yardstick of the worth of stocks. Actually, investment value is completely unrelated to the par figure, which is purely nominal in character.

Accounting for Capital Stock. The no-par feature also permits greater flexibility in the treatment of the capital account. The net worth may be presented in the aggregate or may be apportioned between stock and surplus to reflect managerial policy. Similarly, there is greater ease in adjusting the capital structure to recognize marked changes in the value of the assets. The laws of many states specify a minimum stated value for no-par stock. In most cases, the minimum requirements are nominal in character and do not represent any important restriction on accounting policy.

On the other hand, the advocates of par stock point out the following disadvantages of no-par stock to the interests of the public:

Effect on Credit. The reduction of the liability of the stockholders is said to weaken the credit rating of the corporation because of the more limited protection to creditors. However, credit is usually granted on a going basis instead of expectancy of liquidation; and few par stocks carry any assessable liability.

Aid to Unscrupulous Promotion. The claim is made that no-par stock aids the unscrupulous promoter in selling securities because of the lessened liability as well as in facilitating the transfer of stock for his services and other intangible items. On the other hand, no-par value is an invitation to the prospective investor to study the facts of the case, whereas par value often leads him to accept the value stated on the face of the certificate.

Manipulation of Accounts. First, the absence of a standard of value (par) makes it easy to transfer no-par stock for promoters' services, because of the flexibility in setting up (evaluating) the capital account. Second, after operations are started, the surplus account may also be adjusted to conceal unfavorable conditions or to meet particularized aims of management.

LOW PAR VALUE STOCK

In general, the gist of the arguments against no-par value stock is the granting of excessive and dangerous flexibility to the promoter and financier. Abuse of investor and public interests is obviously possible, but the

use of par value offers little in the way of substantive protection. Low par is just as convenient as no-par as a means of adjusting the capital structure. At the present time, there is little semblance of pattern; and the use of a par value of any amount or its absence is determined mainly by conditions and financial taste. Also, tax laws may have an important bearing on the features of the stock that is being issued.

As specific examples of the casual or incidental character of the par feature, reference may be made to a few recent cases. In late 1960, additional common stock of Kaiser Industries Corporation with a par value of $4.00 per share was offered at $9.75 per share; some three months later it had a market price of 8⅞. Two other examples of 1960 stock flotations are

TABLE 5

CLASSIFICATION OF COMMON STOCKS LISTED ON NEW YORK STOCK EXCHANGE*

Par Value	Number of Issues	
	1960	1956
No-par	191	238
Par of less than $1.00	40	22
Par of $1.00	330	260
Par of $1.01 to $4.99	118	81
Par of $5.00	200	168
Par of $5.01 to $9.99	32	23
Par of $10.00	119	135
Par of $10.01 to $24.99	38	51
Par of $25.00	32	37
Par of $25.01 to $49.99	3	5
Par of $50.00	9	20
Par of $50.01 to $99.99	0	0
Par of $100.00	11	27
Total	1,123	1,067

* Based on count of listings from the *Commercial and Financial Chronicle*, November 28, 1960 and January 2, 1956.

the stock of Western Publishing Company, Inc. with a par value of $1.00 which was offered at $42.00 and the stock of the Organ Corporation of America with a par of $0.10 per share, offered at $3.00. Again, to cite the well-known General Motors Corporation, its preferred stock has no par value; and its common stock has a par of $1.66⅔. Painting the larger picture, the classification of common stocks listed on the New York Stock Exchange according to the par feature may be seen in Table 5. Even a cursory review shows that variety more than uniformity is the outstanding pattern. A par value of $100.00 is now the exception and odd amounts are common; frequently, the latter are simply the mathematical result of splitting the stock. For example, when the General Motors Corporation split its $5.00 par stock 3 for 1, the new stock necessarily had a par value

of $1⅔; in like manner, a similar split of the $100.00 par stock of the American Telephone and Telegraph Company caused the new stock to have a par value of $33⅓.

The low par feature, like no-par, increases the flexibility of the capital account, since the difference between par value and a higher selling price may be credited to a premium or capital surplus account. Particularly may this be a convenience for newly chartered companies because losses may be absorbed during the initial period of development without the need for a stockholders' meeting to get approval. While abuses of this practice may occur, it does not follow that a higher par value without the accompanying capital surplus would assure any greater integrity; under the latter, the potential evil is one of treating expenditures as capital items instead of charging them to expense.

STOCK IN RELATION TO CREDITOR OBLIGATIONS

Appreciation of the nature of stock may be further sharpened by noting its position from the point of view of creditors. Legal and business prudence both regard it as an important basis of credit. And, in the final analysis, this is basically true, since stock provides a margin or cushion of safety which encourages the extension of credit. Because of this relationship between stock and creditor obligations, there is a tendency to regard the former as a form of trust fund to assure the payment of corporate debts. In the ordinary or layman use of the term "trust fund," this concept of the function of stock is likely true; but, in terms of the law, the relationship is regarded by most authorities as a form of contractual obligation. "It is now practically settled . . . that . . . neither the unpaid subscriptions of a corporation nor its other assets are in any proper sense a trust fund for creditors. The true and only ground of the doctrine is fraud; that is, the liability of a subscriber for stock in a corporation rests upon the obligation of his contract."[4]

The relationship between stockholders and creditors may be seen in various phases of corporate activity, of which we may note the following: (1) as it relates to unpaid stock subscriptions and (2) as it affects the right of corporations to purchase their own stock.

Liability for Unpaid Subscriptions. Broadly speaking, it is believed that creditors have a right to rely upon the amount of stock which any corporation represents itself as having. Consequently, in the case of stock having a par value, it is presumed that this declared value constitutes public notice and that stockholders would be liable for any unpaid portion of the subscription price. Basically, of course, the liability would be to the corporation; but this need not deter creditors from seeking to enforce their demands upon the stockholders. Similar application of this

[4] William Meade Fletcher, *Cyclopedia of the Law of Private Corporations* (rev. and permanent ed.; Chicago: Callaghan & Co., 1931), Vol. XI, chap. 58, pp. 576–78.

basic theory has been made where the stock has not been fully paid in the sense that assets of equivalent value were not given for the purchase of the stock.[5] Conceivably, this latter thought could apply also to no-par stock; but the burden of proof upon the creditors in this instance would be much more difficult to establish.

Right of Corporation to Purchase Its Own Stock. Turning to the question arising if corporations buy their own stock, it is apparent that any such purchase must necessarily reduce the underlying basis of credit support. There is no issue where such right is expressly set forth in the statute, as it is in the state of Delaware and others; but where this is not the case, there is much less clarity of the right. Those courts which hold that a corporation cannot buy its own stock without an express grant contend:

1. That corporations cannot increase or diminish their capital stock without the sanction of the Legislature.
2. That such a transaction is a fraud upon creditors.
3. That it is foreign to the purposes for which the corporation was created.[6]

While these reasons appear to be substantial, their application depends upon the intent of the law—not upon the ethics of the case. Where the law is silent on the right, as it often is, it would appear that "the clear weight of authority upholds the right of a corporation to buy its own stock if the purchase is made in good faith and does not prejudice the rights of creditors."[7] The circumstances that could affect the application of the authority are usually found in the intent and the results of the purchase. If such action led to insolvency, or even anticipated it, the courts would undoubtedly hold it to be illegal. "Courts have conceived it to be their duty to detect and defeat any scheme or device calculated in any way to place this fund [the stock] beyond the reach of the creditors."[8] One other test which is frequently recognized is the measurement of the reduction in the stock against the amount of surplus; if it is less, the presumption would favor the purchase unless there were evidence of fraud.

STOCK TERMINOLOGY

Regardless of whether the stock is par or no-par, there are certain terms used in connection with stock issues with which the reader should be familiar. Authorized stock, issued or outstanding stock, capital stock, treasury stock, and donated stock are terms that are common in any discussion of stock. Brief definitions covering these items follow:

[5] *Ibid.*, p. 575.

[6] *In re Fechheimer Fishel Co.*, 212 Fed. 357, 360–61.

[7] *Ibid.*, p. 361. See also W. W. Cook, *A Treatise on the Law of Corporations Having Capital Stock* (Boston: Little, Brown & Co., 1913), Vol. I (7th ed.), sec. 311.

[8] 212 Fed. 357, 365.

Authorized Stock. This is the amount of stock that the corporation is permitted to issue according to the statement in its certificate of incorporation. The authorization may be for common stock alone, or for preferred stock in addition.

Issued Stock. The amount of authorized stock should be large enough to cover present and anticipated future needs. By this means, there will be sufficient stock for financing future expansion, for paying stock dividends, and for other purposes. Otherwise, the charter would have to be amended whenever additional stock was needed. The stock that has been sold is known as "issued" stock, and the balance is classified as "unissued."

Capital Stock. Purely for the purposes of acquainting the reader with terminology that is commonly used, reference may also be made to capital stock. It is not possible to set forth any hard and fast definition, since it is given a wide variety of meaning: "aggregate ownership interest," "authorized capital," "common stock only," and "both preferred and common stock." There is little to gain here by trying to rationalize a specific meaning; and, in general, it may be said that the term may be considered as synonymous with "stock."

Donated Stock. As indicated earlier in this volume, donated stock represents a gift to the corporation of its own stock. The donation is almost always made by a friendly party of interest who makes the stock available so that it may be sold to outsiders in order to raise additional cash. The action may be taken with or without intent to use it as a subterfuge to avoid liability provisions.

Treasury Stock. In financial and accounting usage, treasury stock is considered to be any stock of a corporation that has been issued and reacquired. The latter usually is effected by purchase, or by donation as previously described. While some authorities go so far as to declare that unissued stock should never be treated as treasury stock, it should be noted that legal definition of the term is less consistent and various opinions hold that unissued stock may also be included.[9]

EVALUATION OF FINANCING WITH COMMON STOCK

The advantages and disadvantages of an investor's holding common stock were referred to at the outset of this chapter. Analysis from the corporate point of view is equally important. In many ways, common

---

[9] See *In re Public Service Holding Corporation*, 24 Atl. 2d, 584, 586, for opinion that "stock which is merely to be held unsubscribed for and unissued is not usually regarded as treasury stock." However, Fletcher, *op. cit.*, Vol. XI, chap. 58, pp. 44–48, observes that some courts regard purchased or donated stock as assets acquired in the furtherance of corporate purposes and that "treasury stock is stock reserved at the time of organization . . . and in respect to mining stock it has been held to mean 'such stock as is set aside for the actual development of the property.' "

stock constitutes an ideal source of funds for the corporation. The pertinent reasons for this may be summarized as follows:

Absence of Fixed Payments. In contrast to bonds—which require a recurring, fixed payment of interest, and payment of principal either in installments or by a lump-sum maturity, irrespective of the financial status of a company—common stock makes it possible for management to exercise its discretion. For example, if business is depressed and the earnings of a corporation are lowered materially, sound financial policy may require the passing of dividends. Default of interest on bonds would precipitate failure, but the omission of dividends has no such serious consequences. As a result, stocks provide a cushion of safety against temporary unfavorable developments.

Improved Credit Standing. Extensive use of common stock to raise capital also improves the credit position of the corporation. Automatically, the enlargement of the residual equity increases the base of credit operation. Unfortunately, weaker companies may not be able to sell common stock when they are in need of funds and may be compelled to resort to borrowing of some type. As discussed in Chapter 13, financial policy is often shaped by pressing expediency which permits little choice.

More Economical Financing. Over an extended period of time it is generally more costly to finance with stock than with bonds, but there are occasions when this normal relationship may be upset. Such was the case in the late twenties when speculative enthusiasm created public sentiment that contemplated a new era; as a result, stock was deemed to be a means of participation in the anticipated expansion.

Again, in recent years, the relative demand for stock has been characterized by considerable vigor—not only because of inflationary influences but also because of the thought that stock is an integral part of a balanced investment program. As a result, the return on stocks has been less than that on bonds for a number of years. Like any other price, the cost of money is an expression of supply and demand conditions. As the existing pressures exhaust their force, the normal relationship between stocks and bonds will undoubtedly be restored.

Despite the obvious advantages of common stock financing, there are many reasons why it is not generally used as the sole medium to raise capital. In the first place, stocks are not always acceptable. There is a large element in the investing group which will not buy stocks either because of choice or because of legal restriction. Also, for smaller companies, stocks may not be salable in sections where they are not known; under these circumstances, bonds with their legal protective provisions are more attractive.

Second, as indicated above, bonds generally sell at lower rates than stocks over a long period of time. In addition, the issuance of common stock necessarily has a bearing upon the control of the corporation; and there may be a desire to hold the amount of stock within limits that will not unduly disturb the status quo.

Finally, the sale of more common stock increases the base over which any future appreciation in value or increase in earnings must be spread. Granted that stockholders give priority to the safety of their investment, they also have an eye upon the return potential. In the background, there

is likely a psychological reluctance to share their good fortune with newcomers.

RIGHTS OF COMMON STOCK

With the issuance of common stock, the corporation assumes definite responsibilities and obligations to the holders of the stock. At the same time, it is essential to remember that the stockholders simply own the corporation; and the title to the property is lodged in the corporate name. Because of this breach between the stockholders and their ultimate property, it is necessary to provide them with sufficient rights and powers to afford adequate protection. This is achieved mainly through the following channels: (1) the power of stockholders to elect those in control; (2) the exercise of pre-emptive rights; and (3) the use of various other rights provided by law.

POWER OF STOCKHOLDERS TO ELECT THOSE IN CONTROL

Because the stockholders have the power to elect the board of directors, it is sometimes believed that they are fully protected against mismanagement, fraud, etc. While the importance of this right may not be denied, its significance is not generally realized by the great mass of stockholders. The privilege is abused and neglected in much the same manner as political suffrage, i.e., by inaction and disinterest. Furthermore, except on a few occasions, the stimulus arising from party competition or other forms of opposition is lacking. These conditions, combined with remoteness of many stockholders from the scene of operations, create a tendency not to regard voting seriously. Again, the stockholder often contends that he is uninformed as to the technical operations of industry and is unable to vote intelligently. In reply, it should be pointed out that he is not voting upon operations but rather upon the selection of personnel to supervise the activities of the company. Stockholders having few shares are especially inclined to believe that their voice would be of little significance and to refrain from exercising their privilege.

Under these circumstances, it is comparatively easy for the active few to secure complete control of a business enterprise.[10] In fact, concentration of control is now generally recognized to be the *modus operandi*, particularly for large corporations. Occasional abuses of trust are given great publicity; but, nevertheless, the student of finance and corporate policy must be conscious of that great body of business enterprises functioning so efficiently that their merit is lost in silence. As a protection against the exceptional abuses, the right of the stockholder to vote may be a most potent weapon.

[10] See Chapter 14 for a more detailed description of how this may be accomplished.

CLASSIFIED STOCK

To avoid the inconveniences of mass voting, as well as to afford a ready and economical concentration of control, some corporations classify their common stock for the purpose of restricting the voting rights. Under one plan, there are two classes of stock, generally designated as A and B. The latter usually has the right to elect a majority of the directors. This was true of the Devoe and Reynolds Company until September, 1959; the A stock elected one-third of the directors and the B stock the remaining two-thirds. However, as of the date indicated, both classes were exchanged for a single class of common stock. In the North American Cement Company, there is one vote for each share of A and B stock, but the latter has the right to elect a majority of the directors. In the Bon Ami Company there are more B than A shares, and the control by the former is the result of a numerical advantage.

Liquidation and priority-of-dividend rights of classified common stock lack uniformity. However, it may be said that it is not uncommon to find the Class A stock having a preferred status on both counts. In this event, the A stock basically assumes the nature and character of preferred stock, which will be discussed at length in the next chapter.

Another classification divides the stock into common and either A or B. For example, the capital stock of the R. J. Reynolds Tobacco Company consisted of common stock and common B stock for a long period of time. Each class had equal voting and dividend rights except that employees and officers owning the common stock were allowed to share in additional profits. However, the company adopted a plan pursuant to which each share of common stock was eligible for exchange into 1¼ shares of B stock until March 31, 1959, and thereafter on a share-for-share basis. The conversion was successful, and, in April, 1959, the stock was redesignated as common stock. Until 1948, the American Tobacco Company also had common stock and common B stock; but, in this instance, the latter did not have voting rights.

The most striking recent example of the use of classified stock is found in the transition of the Ford Motor Company from a closed to an open corporate status in 1956. Before the change, 172,645 shares of voting B stock were held by members of the Ford family; and 3,322,395 shares of nonvoting A stock were owned by the Ford Foundation, a small number of key employees, and Ford family interests. After the transition, there are three new types of stock—common stock and B stock each with voting rights and A stock without the right to vote. The B stock, equal to only 12.1 per cent of the shares of all types of stock, holds 40 per cent of the total vote.[11]

The use of classified common stock probably responds to the tempo

---

[11] See p. 238, after, for a more complete analysis of this case.

of business conditions; when they are favorable, and stockholders are the beneficiaries of good earnings or dividend returns, there is little adverse sentiment toward its use. The halo of the "favored son" adorns management and it is given extensive freedom of action. However, under more stringent circumstances, both stockholder and public reaction points in the direction of management restraint.

To illustrate these passing moods, it may be noted that classified stock had considerable popularity during the buoyant twenties, but came under sharp scrutiny during the depression of the thirties. The Securities and Exchange Commission was given power to require common stock issued by companies subject to the Public Utility Holding Company Act of 1935 to carry equal voting rights with other securities. Under this authority, the right to issue new nonvoting stocks may be denied, although presumably any unissued, but authorized, nonvoting common could still be issued. The Bankruptcy Act requires equitable distribution of voting power in the reorganized company and prohibits nonvoting common stocks. As a reflection of the prevailing governmental policy, the New York Stock Exchange has instructed its Listing Committee to give consideration to the question of voting control on all new applications for listing. In recent years, the attitude toward the use of classified stock is once again responding in typical manner to the well-known high level of business activity. However, for those companies subject to regulatory review, there is avoidance of the extremes to which the practice was carried in earlier years.

PRE-EMPTIVE RIGHTS

Another vital right which serves to protect the shareholders against possible abuse is that of pre-emption.[12] By force of judicial decision, stockholders have the first option to buy additional issues of stock in proportion to their existing holdings. The purpose of this compulsion is clear, viz., to preserve and protect the interests of the shareholders in the assets and the control of the corporation. Without this requirement, inside interests could easily sell additional stock to themselves in order to swing the balance of control.

Protection of the proportionate interests in the surplus of a corporation is also effected by virtue of the pre-emptive right. Not infrequently, new stock is sold at a price that is less than the book value of the outstanding stock, and there is inevitable dilution of the shareholders' equity.[13] Let us assume a corporation having 1,000 shares of stock and an earned surplus of $50,000, or $50 per share. The decision is made to sell another 1,000 shares of no-par stock and to capitalize it on the balance sheet at the

[12] Stockholders voluntarily may forfeit this right, or in some states the corporate charter may provide that stockholders are not to have the right of prior subscription.

[13] See pp. 362–64.

stated or nominal value of the old shares. After this operation is completed, each share will have a proportionate interest of only $25 in the surplus. Hence, the stockholder who does not receive rights to the new issue will lose half of his accumulated prior earnings.

An interesting exception where the pre-emptive right apparently is not applicable is the issuance of shares for the purchase of property.[14] In this instance, it is likely that consideration is given to the assumption that the exchange would be on a *quid pro quo* basis. In other words, it would be presumed that the shares would be issued on the basis of their existing value, unlike a new issue sold for cash where it is customary to fix a price below the market value of the old shares. At the same time, it should be noted that this exception fails to preserve the earlier distribution of control.

OTHER RIGHTS OF COMMON STOCK

Stockholders also have the right to inspect the books of the corporation. Opportunity is thereby provided to prevent the inside forces from concealing the facts of operation. At the same time, it is quite possible to employ this privilege for ulterior reasons. For example, a competitor may buy stock expecting to exercise this right of the stockholder to inspect the books—for all practical purposes, a form of espionage. However, if it can be shown that a stockholder desires to examine the books for unscrupulous reasons, the right will undoubtedly be denied in a court of equity. In addition to these more specific rights of protection, stockholders have such general privileges as the right to transfer stock, the right to receive dividends, the right to share in the proceeds of dissolution, etc. Stockholders possess most of the characteristics of owners of any other property.

FOUNDERS' AND MANAGEMENT STOCK

Founders' shares and management stock, as the terminology suggests, are held by inside interests in order to facilitate their control or to favor them with special dividend privileges. Such stock naturally represents only a relatively small amount of the total capital, since the purpose is to reward those who are accredited with unique or special contributions to the initiation and success of the enterprise. This type of stock is not popular in this country, but it is desirable to understand its occasional use. An example is found in the reorganization of the Goodyear Tire & Rubber Company in 1920. To raise the funds necessary to re-establish the company, 8 per cent gold bonds were included as part of the capital program. At the same time, it was specified that as long as these bonds

[14] See A. A. Berle, Jr., *Studies in the Law of Corporation Finance* (Chicago: Callaghan & Co., 1928), pp. 144–45.

were outstanding, the control (the right to elect a majority of the board of directors) should be vested in three men,[15] either by means of management stock or by means of a voting trust. The management-stock plan was employed and was in effect until 1926, when the bonds were replaced by a new issue.

The New York Shipbuilding Corporation is an example of a company that employed founders' stock as a control device. Until replaced by the usual common stock in 1953, the corporation had an authorized issue of 212,830 shares of $1.00 par founders' stock, of which 175,000 shares were outstanding. This stock had sole voting rights at the rate of one vote for each share and was entitled to a flat 35 per cent of the earnings; the remaining 65 per cent of the earnings went to the nonvoting participating stock, of which there were 1,000,000 shares authorized and 325,000 shares outstanding. The latter was also exchanged for common stock in connection with the change in the capital structure in 1953. The revision of the capital account occurred when the Avco Manufacturing Company sold its holdings (59.3 per cent of the total) of the founders' stock.

CERTIFICATES OF BENEFICIAL INTEREST

Another type of security issued for control purposes is the certificate of beneficial interest. This certificate represents stock deposited with the trustees of a voting trust (a group of trustees with power to exercise the voting rights of stock) and gives the holder a proportionate interest in the earnings and assets of the issuing corporation without voting power. The trustees hold the voting rights to the deposited stock and are, therefore, able to exercise centralized control over one or many corporations. The control is relatively permanent because the trust is ordinarily for a long period of years, and the board of trustees is a self-perpetuating body.

The Great Northern Iron Ore Properties may be cited as an example of the trust form of organization for control purposes. This trust was organized in 1906 and is to continue for 20 years after the death of the last survivor of 18 named persons, the youngest of whom was born in the same year, 1906. Originally the trust was of a holding nature, but, in 1956, all subsidiaries were dissolved; as a result, the trustees now own the constituent properties in fee, and function on the basis of a Massachusetts trust (see p. 23). Upon organization, the trust issued 1,500,000 nonvoting shares or certificates of beneficial interest to the stockholders of the Great Northern Railway Company. Dividends of $0.50 to $4.00 have been paid every year with the exception of 1932 and 1933.

SPECIAL CLASSES OF STOCK UNDER PRESENT-DAY CONDITIONS

Since 1933, there has been a decided change in the public attitude toward business corporations. Many of the regulatory measures under-

[15] J. Dillon, John Sherwin, and Owen D. Young.

taken are intended to increase the degree of democracy in the control of business. Corporations are required to give full and complete information about each issue of stock, its obligations, its rights, and its purposes. Founders' and management stock clearly do not harmonize with this trend to enlarge the public interest. While this type of stock has never been popular in this country, it may be symbolic of an objective that may be sought in various guises—assurance of control by minimum investment. Particularly is there a tendency in this direction in extremely prosperous times, such as we have had in recent years. Applicable regulatory measures developed to meet earlier abuses may serve as a deterrent to some degree, but, in the long run, the pattern of private conduct will be fixed by the level of its own standards—both financial and moral.

QUESTIONS AND PROBLEMS

1. Discuss the nature of "residual ownership," and evaluate its significance for large and small corporations.
2. Discuss from the management point of view the importance of common stock as an underlying basis of the corporate financial structure.
3. Discuss the accounting and financial connotations of net worth.
4. Discuss the relationship between the earnings, book and market values per share of the following companies (data for or as of the close of the year 1959):

	Market Price	*Book Value*	*Price X's Earnings*
Bethlehem Steel Corp.	\$ 54½	\$34	22.3
United States Steel Corp.	98⅝	52	23.2
Chrysler Corp.	68⅛	77	Def.
General Motors Corp.	54½	18	17.8
General Electric Corp.	99⅛	17	31.1
Westinghouse Electric Corp.	109⅜	38	22.5

5. In an article entitled "An Unruly Rule-of-Thumb" (see *The Exchange*, June, 1960, p. 18), it was reported that of 40 common stocks "picked pretty much at random—20 were selling recently for less than ten times earnings; 20 for more than 25 times." Discuss the general reasons for such disparity, and comment on the following specific cases: (*a*) American Sugar Refining and International Harvester which were selling for less than 7 times earnings. (*b*) International Business Machines, Minnesota Mining & Manufacturing, Polaroid, and Texas Instruments—each of which was selling for more than 50 times earnings.
6. Discuss the influence of general economic conditions upon earnings trends, and comment on the statement that "favorable over-all economic conditions may conceal the real capacity of management."
7. In recent times, governmental contracts have been an important factor in shaping general economic conditions and in determining the earnings results of many companies. Discuss the following: (*a*) The means of obtaining such contracts. (*b*) The financial problems resulting from the contracts.
8. Discuss the statement on page 73 that "Speculative responses do not . . .

have direct effect upon the financial status of a corporation, but . . . may indirectly affect policy as well as the raising of new capital."

9. Appraise the arguments for and against the use of (*a*) no-par stock, (*b*) low par stock.
10. Prior to its transition from a closed to an open corporation, the Ford Motor Company had 172,645 shares of B stock and 3,322,395 shares of A stock outstanding, the former being held by the Ford family and having the sole voting power. After becoming an open corporation, 60 per cent of the voting rights resided in stock held by interests other than the Ford family. Discuss the reasons for making this change and evaluate its significance.
11. Do you believe that corporations should have the right to buy their own stock?
12. Discuss the "trust fund" concept of stock.
13. Discuss the relations between management and the common stockholders from a legal point of view. Discuss from a business point of view. Also distinguish between the relations that exist in small companies and those in large companies.
14. Summarize the arguments for and against the use of nonvoting stock.
15. "Nonvoting stock is a device for control more than it is a medium of financing." Discuss.
16. Discuss the advantages of the pre-emptive right to a stockholder. Discuss the disadvantages to corporate management.

REFERENCES

Bogen, J. I. (ed.). "Corporate Stock," *Financial Handbook*, pp. 405–21. New York: The Ronald Press Co., 1954.

Bonbright, James C. "The Dangers of Shares without Par Value," *Columbia Law Review*, Vol. XXIV (May, 1924), pp. 449–68.

Bradley, Joseph F. *Fundamentals of Corporation Finance*, chaps. x, xi. New York: Rinehart & Co., Inc., 1959.

Buchanan, N. S. *The Economics of Corporate Enterprise*, chap. iv. New York: Henry Holt & Co., Inc., 1940.

Fletcher, William Meade. *Cyclopedia of the Law of Private Corporations*, Vol. 11, Rev. and permanent ed. Chicago: Callaghan & Co., 1932.

Friedrich, A. A. "Stocks and Stock Ownership," *Encyclopaedia of the Social Sciences*, Vol. XVI, pp. 403–7.

Gerstenberg, Charles W. *Financial Organization and Management of Business*, chap. v. Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1959.

Johnson, Robert W. *Financial Management*, chap. xv. Boston, Mass.: Allyn and Bacon, Inc., 1959.

Statistics of American Listed Corporations (A Work Projects Administration Study Sponsored by the Securities and Exchange Commission, 1940), Part I, pp. 23–25, and supporting tables.

Stevens on Corporations, secs. 24, 86, 108–11, 170–71. St. Paul: West Publishing Co., 1936.

Chapter 6 ►

PREFERRED STOCK

WHAT'S IN a name? Possibly this homely philosophical inquiry suggests, more than any formal pronouncement could, the nature and the problems of preferred stock. Preferred over what? Does the preference have substance? Or is the term just another example of the tendency in finance to use alluring titles? Simply to ask these questions indicates the uncertainty of the status of preferred stock. Also, the confusion is of long standing. More than a century ago, an English court spoke as follows: "The expression 'preference shareholder' is equivocal. It by no means clearly indicates what are the rights of those to whom it applies. . . . All which the language fairly imports is that *some* preference is given to the persons to whom the language applies. How far the preference is to extend must be ascertained by other media than the mere expression itself."[1] This same observation is equally pertinent in our own financial world of today.

There is little uniformity of thought about preferred stock from the point of view of either the investor or the corporation. On the one hand, a well-known authority has said: "From the financial point of view, cumulative preferred stocks have little to recommend them."[2] On the other hand, a different observer, in speaking of the lot of the preferred shareholders, declared that they are "euchered, cajoled, elbowed, and traded out of their legal rights."[3] Even so, if volume be any criterion, preferred stocks have wide acceptability as a form of investment and are freely used by management as a medium of financing. With such a setting, it becomes all the more important to understand their characteristics.

---

[1] *Henry* v. *The Great Northern Railway Company*, 1 DeGex & Jones (November, 1857), p. 636. Incidentally, it may be noted that the case arose mainly as a result of an embezzlement of more than $1,000,000 by the registrar of the company, again suggesting that our current problems are by no means new.

[2] W. H. S. Stevens, "The Discretion of Directors in the Distribution of Noncumulative Preferred Dividends," *Georgetown Law Journal*, January, 1936, p. 393.

[3] Statement of Commissioner Healy, Securities and Exchange Commission, *Decisions and Reports* (Washington, D.C.: U.S. Government Printing Office, 1937), p. 1024.

RIGHTS OF PREFERRED STOCK

Despite its conglomerate nature, preferred stock may be defined as part of the capital stock of a corporation. It differs from common stock in that it usually has a right of priority of dividends as well as to principal in the event of liquidation. The prior claim to dividends is a recurring right which is applicable to all income periods; that is, the preferred stock is entitled to receive dividends before any may be paid to the common stock. Often, neither the common nor the preferred stock may receive any dividends; but if dividends are declared at all, they must be paid first to the preferred stock. To complete its priority over common stock, the preferred usually takes precedence in the event of liquidation. Under either voluntary or involuntary liquidation of the company, the preferred stock is entitled to be paid in full from the remaining assets before any payments may be made on the common stock.

Almost always accompanying the preference feature is a limitation on the rate of dividends and on the amount of assets to be received in the event of voluntary or involuntary liquidation. As a result, there is little opportunity to share in unusual earnings or to derive major benefits from appreciation in the value of the original corporate investment. And, unlike all bonds, except a comparatively small amount of the income variety, preferred stock does not have any contractual guaranty of income, the payment of the dividends being largely at the discretion of the directors of the corporation. Needless to say, it is junior or subordinate in all respects to the claims of all forms of creditor obligations. In short, it is a hybrid security with all the popularity and condemnation which so often attach to this type of object.

FEATURES OF PREFERRED STOCK

Standing in a middle area between bonds and common stock, preferred stocks may have a great variety of adorning features. Some are used to entice or protect the investor, while others provide an escape whereby corporate management may effect desired changes in financial policy. Also, general money-market conditions and the financial position of the issuing corporation exercise significant influence. When money is plentiful, or if the corporation has a high investment rating, dividends may be noncumulative instead of cumulative and fixed provisions for the retirement of the preferred stock may be avoided. Opposite conditions would necessarily favor restraints intended to give an advantage to the investor. Such underlying influences may be seen more readily by giving attention to the following characteristics of preferred stock: (1) use of par or no-par value, (2) dividend provisions, (3) the right of redemption, (4) provision for a sinking fund to facilitate the retirement of the stock,

(5) conversion rights, (6) participation in earnings in excess of the stated dividend rate, (7) protection against the issuance of additional securities, (8) voting privileges, and (9) the dividend rate.

PAR OR NO-PAR VALUE

Since a stated or fixed rate of dividends is a common feature of preferred stocks, it would be expected that par value would be used more particularly with preferred than with common stocks. A quick check of the listings on the New York Stock Exchange as of late 1960 shows this to be the case, some 220 out of 382 issues having a par value of $100. Of the remainder, 100 had a par value of some other amount ($50 being the most common); and 62 had no-par value. Naturally, when preferred stocks do not have a par value, the dividend is necessarily stated in terms of dollars; for example, there may $3.00 preferred stock, $7.00 preferred stock, etc.

With respect to industry groupings, the no-par feature is seldom found in the railroad field; but it is fairly common in both the industrial and public-utility areas. The arguments for the use of no-par in connection with preferred stock are basically comparable to those presented in Chapter 5. In brief, the chief merit is said to be the greater flexibility which it gives to financing, although again it may be pointed out that the use of a low par should provide almost equal advantages. The historical influence of a par value of $100 is more pronounced in preferred than in common stocks, but it is likely that market and legal factors will increasingly set the pattern in the future.

CUMULATIVE AND NONCUMULATIVE DIVIDENDS

Dividends on preferred stock may either accumulate when not paid, or they may be noncumulative and expire at the end of each dividend period. The reason for making dividends on preferred stock cumulative is best explained by describing what happens when they are noncumulative. Under the latter plan, if the dividends are not paid during a given period, the stockholder is no longer entitled to receive them, assuming, of course, that the omission of the dividend is legal.[4] Automatically, the failure to pay a dividend on the preferred means that nothing may be paid on the common.

Let us now assume that a corporation could earn in a given year only enough to cover the preferred dividend, and that the directors determined not to declare its payment. Next, we may presume that earnings are sufficient the following year to pay dividends on both the preferred and com-

[4] See Stevens, *op. cit.*, for more exact analysis of the rights of noncumulative preferred shareholders under varying circumstances.

mon stock. Under these conditions, it is apparent that by the simple expedient of omitting the earlier dividend on the preferred, it becomes possible to pay dividends on both classes of stock. This would hardly be termed an ethical procedure but probably could be defended in many cases as being legal. In any event, preferred stockholders would be called upon to use personal funds to protest the action in court, while the defense would be financed out of corporate money. However, such a practice would be impossible when the stock is on a cumulative basis, because dividends not previously paid are added to those currently due and the total obligation must be discharged before common stock may receive anything.

As a point of law, preferred stock is assumed to be cumulative, unless there is a statement to the contrary either in the charter or in the bylaws of the corporation.[5] Notice of such restrictions must be printed on the back of each stock certificate. Prevailing legal interpretation gives the preferred stockholders all the rights of the common stockholders if there are no limitations to the contrary. Because of the extensive implied powers inherent in preferred stock, most companies take great care to provide the necessary restrictions. The following extract from the certificate of the American Can Company may be quoted as an instance: "The Preferred Stock is entitled in preference to the Common Stock, to cumulative dividends at the rate of seven per centum (7%) yearly and, in any distribution of assets other than profits, to the full par value thereof and the amount of such cumulative dividends then unpaid, but to no other dividend or share in distribution. . . ."[6]

Obviously, the cumulative feature provides a degree of protection to the investor while placing some pressure on management to maintain the dividend payments. In reality, preferred shareholders are at a considerable disadvantage in enforcing their rights to accumulated dividends, being largely dependent upon the actions initiated by those in control.[7] At times, ensuing prosperity makes it possible to pay off arrearages of fairly long standing; but often it is necessary to work out a settlement with the

---

[5] See *Moran* v. *U.S. Cast Iron Pipe and Foundry Co.*, 95 New Jersey Eq. 389 (1923), wherein it was held that dividends on noncumulative preferred stock accumulated to the extent that they were earned, whether paid or not. For an able exposition of the equity of this position, see A. A. Berle, Jr., *Studies in the Law of Corporation Finance* (Chicago: Callaghan & Co., 1928), pp. 96 ff.

The more usual viewpoint is that noncumulative preferred has no rights to current earnings unless the directors choose to declare dividends, *provided* the earnings are applied to justifiable corporate purposes (*Wabash Railway Co.* v. *Barclay*, 250 U.S. 197 [1930]). For a careful appraisal of both viewpoints, see W. H. S. Stevens, "Rights of Non-cumulative Preferred Stockholders," *Columbia Law Review*, Vol. XXXIV (1934), p. 1439.

[6] In April, 1952, the stock was split 4 for 1, and now has a par value of $25.00.

[7] See William O. Douglas, *Democracy and Finance* (New Haven: Yale University Press, 1940), p. 134, for estimates that in 1938 some $432,000,000 of arrears on preferred stocks of public-utility companies existed.

preferred stockholders. Illustrative of the liquidation of arrearages is the payment in cash in 1950 of $29.75 per share on the $7.00 no-par cumulative preferred stock of the Curtis Publishing Company; in the same year, the General Steel Castings Corporation made a payment of $35.50 on its 6 per cent preferred stock, leaving an unpaid balance of $20. Still later, the remaining accrual was paid, and, in 1955, the stock was retired at $110 per share. When a settlement is effected with the stockholders, it is common to issue a new security to replace the outstanding issue and to compromise the dividends. Two examples of such practice may be given.

The difficulties of the American Zinc, Lead and Smelting Company were, in a sense, self-imposed. In 1916, it paid a 50 per cent dividend on the common stock in $6.00 cumulative preferred stock, par $25. Dividends on the latter were paid regularly until 1920; but, from this point to the settlement of the problem in 1935, there were only 6 quarterly payments. As a result, unpaid dividends accumulated to the extent of $82.50 per share. The stockholders then voted to clear up the arrearages by the payment of 6 shares of old common stock, which was selling for approximately $5.00 per share at the time; in other words, the accumulated dividends were settled for about $30. In addition, a new issue of convertible prior preferred stock with a cumulative dividend rate of $5.00 was substituted for the original $6.00 stock on a share-for-share basis. All rights of the new issue were the same as the old except for the addition of the conversion privilege at the rate of 4 shares of common for one share of preferred. In 1954, the preferred stock had a price range of 73 to 94½, and, in 1955, the stock was called at the redemption price of $100 plus dividends. However, practically all the stock was retired by voluntary conversion because of the attractive price of the common stock at the time of the call.

The stockholders of the Allied Stores Corporation approved, in May, 1935, a recapitalization plan which cleared the dividend arrearages and replaced the old stock. Each share of the old 6½ per cent preferred received one share of new 5 per cent preferred stock; $15 in principal value of 15-year, 4½ per cent debentures; 2 shares of common stock; and $3.00 in cash. Since that time, both the debentures and the preferred stock have been retired, the latter being replaced in 1945 by a new 4 per cent cumulative, preferred issue. Inasmuch as the early arrearages amounted to only 13 quarterly dividend payments totaling $21.13, it is apparent that the stockholders who held their investment were able to recoup their loss.

The long period of favorable economic conditions in recent years has facilitated the settlement of most dividend arrearages either by payment or compromise, but a number of instances persisted for a long period of time. The problems arising out of the 7 per cent cumulative preferred stock of the Missouri, Kansas and Texas Railroad Company were not resolved until 1958, by which time the accrued unpaid dividends exceeded $150 per share. The solution took the form of familiar expediency—the

replacement of the old contingencies by those of a different variety. In brief, each share of the old 7 per cent stock received the following: $100 subordinated income debenture 5½'s, due in 2033; 1 share of common stock; and $110 of "noninterest bearing certificates" with no maturity. More fortunate were the holders of the $7.00 first preferred of the Western Maryland Railway; in 1955, they received a cash payment of $116 per share to discharge the dividend accruals. One other example is the $4.00 cumulative class A common stock of the Long Bell Lumber Company with dividend accruals of $87.90 per share as of March 2, 1955; in November, 1956, the stock and accrued dividends were eliminated as a result of merger of the company into the International Paper Company. Under the plan, each share of stock received .65085 shares of common stock of International and .03829 "units of contingent interest."

REDEEMABLE PREFERRED STOCK

The majority of preferred stock issues gives the right to the directors to pay off the stock at any time upon proper notice to the stockholders. In other words, the stock is callable or redeemable at the option of the company. From the point of view of the latter, the advantages of this feature are perfectly clear. Not only does optional redeemability permit a more flexible financing program, but it provides an opportunity to use periods of easy credit and low money rates to issue new securities with more favorable terms. Preferred stock has a relatively high dividend rate and other attractive features which may at times prove to be undesirable, if not unnecessarily deterring, to the management. The redemptive privilege offers a convenient means for the removal of these restrictions. Since the exercise of the option is at the discretion of the company, it may come at a time that is detrimental to the investors who hold the stock. As a result, the redemption price usually includes a premium—meaning that the stock is callable only at a figure above par, or above the original issue price in the case of no-par stock. For $100 par stock, the premiums may vary from $5.00 to as much as $20 per share in the event of call.

The use of the call privilege likely reflects the hybrid or special nature of preferred stock, the varying conditions of the issuing companies, and the state of the money market at the time the stock was issued. When the latter requires a comparatively high dividend rate, management naturally favors inclusion of the redemption privilege in order to establish a basis for later refunding. However, when the stock is issued as part of a major reorganization to correct basic financial difficulties, such as has been fairly common for railroads, the atmosphere gives little hope for contemplation of future redemption. Finally, it is likely that the feature is more common to stock issued in the last two or three decades because of the increasing emphasis being placed upon the importance of flexibility as a prime requisite of sound, financial arrangement.

SINKING FUND

In a number of instances, a sinking fund may be required to make redemption both more certain and more systematic. This may be done to make the preferred stock more attractive to a certain type of investor, or it may be included in the stock's protective privileges to conform to prevailing market conditions or styles.

The reason for the issuance of the stock may also explain the inclusion of the sinking fund provision. If preferred stock is issued to provide capital for special uses of limited duration, a sinking fund provides a means of orderly liquidation. This feature may be seen in the 3.9 per cent cumulative preferred stock of Philip Morris, Incorporated, which was issued to raise funds to repay bank loans. In the 5 per cent cumulative preference stock of the General Tire and Rubber Company, issued in exchange for the stock of a merged company in 1955, the annual sinking fund requirement is equal to 2½ per cent of the maximum amount issued; if the earnings are not sufficient to cover this allocation, the requirement is waived but is cumulative and constitutes a charge against future earnings. In the 4.2 per cent cumulative preferred stock of the Public Service Company of Colorado, the funds were used for the expansion of plant investment; and there is no sinking fund requirement. As might be expected, the provision for a sinking fund is found more frequently in the industrial field than in either the public-utility or the railroad fields, reflecting the difference in the rate of capital turnover.

CONVERTIBILITY

When preferred stock is convertible, the holders have the option of exchanging it for common stock on the basis of terms prescribed at the time the preferred was originally issued. The use of the privilege is naturally inviting when stock prices rise, and it loses its appeal under adverse price movements. However, the conversion option is often inserted in the preferred stock's rights in the hope that price movements will eventually result in complete retirement of the stock. Generally, the original issuance of the stock is prompted by the need for additional funds for ordinary corporate purposes; but, in recent years, the conversion feature may serve as a means of facilitating exchanges of stock under merger arrangements. Currently there are some 450 convertible stock issues of industrial companies outstanding (see 1960 *Moody's Industrial Manual*, pp. 138–39). Sometimes the terms of conversion become less attractive with the lapse of time, and generally the right expires entirely after a stated number of years. The following cases are offered as examples of convertibility and other features:

Abbott Laboratories Cumulative Convertible 4 Per Cent Preferred. Each share of this stock is convertible into 1.7 shares of common stock to Decem-

ber 31, 1961. Provision was made for calling the stock at 106 through 1958; at 105½ in 1959; and thereafter at 105. The establishment of a sinking fund does not commence until September 1, 1962, at which time an annual amount is to be paid into the fund equal to 3 per cent of the shares outstanding, but without allowance for retirements by conversion.

Carrier Corporation Cumulative Convertible 4.8 Per Cent Second Preferred. This stock was issued in 1957, the total authorization amounting to 200,000 shares. Some 118,000 shares were sold for cash to be used for general corporate purposes, and the balance was available for use in the acquisition of the Elliott Company—specifically, 1.1 shares of the new preferred was exchanged for each share of its 5 per cent second preferred stock. The stock of the Carrier Corporation is convertible into common stock at a price of $63.50 per share until February 1, 1967. The corporation's right to call the stock started at a price of $54.00 to 1960, after which the call price declines $0.50 per share annually until August 2, 1967. Provision is made for an annual sinking fund equal to 4 per cent of the maximum shares issued, less reductions by conversion, redemption, etc.; after 1967, the sinking fund requirement becomes cumulative.

New York Wire Cloth Company. In this case, the 5 per cent cumulative preferred stock is callable at $110 per share, and is convertible into 5¾ shares of common stock. The 6 per cent noncumulative preferred is callable at the same price but is convertible into 5 shares of common stock. No time limit is indicated for the right of conversion, and no provision is made for a sinking fund.

Air Reduction Co., Inc. 4.50 Per Cent Cumulative Convertible Preferred. Some 248,805 shares of this stock were offered in 1951 at a price of $100.00 per share. By December 31, 1959, there were only 6,233 shares still outstanding. The reduction resulted from both the rights of conversion and callability. Conversion of the stock into 3.75 shares of common was authorized to December 1, 1961, and the stock is callable at any time at a price of $101.50 per share. The sinking fund requirement provides for an annual amount equal to 3 per cent of the shares outstanding at the end of each year but may not exceed the annual consolidated net income in any one year, after allowance is made for dividends on the preferred stock.

U.S. Industries, Inc. Cumulative Convertible 4½ Per Cent Preferred. Issued by the Pressed Steel Car Company, Inc., this stock was assumed by the indicated company when the name was changed in 1954. This stock was convertible into common stock to December 31, 1955, but, as of the close of 1959, some $1,782,300 was still outstanding. A sinking fund charge is required only in the event net earnings are realized, and the stock is callable at any time at 52½. Sold in late 1945 when the company earned $10.79 per share, the stock failed to earn anything in the following year; the regular dividends have been paid quarterly since April 1, 1946.

Some question may be raised as to the fairness or necessity of attaching the provision of convertibility at all. Preference as to dividends exists from the beginning; and, in most cases, the stock has prior claim to the assets in the event of liquidation. Under these conditions, why should the holders of the stock be given protection in the early life of a corporation with an opportunity later to enjoy the results of its success? In answer to this question, it should be pointed out, first of all, that undoubtedly a higher price is paid for the stock than would otherwise be paid

if there were no opportunities for conversion. In other words, the privilege is not a gift but is actually purchased by the security holders. In the second place, the attachment of the conversion feature makes the stock more marketable and brings a higher price as well.

The conversion privilege is an option to buy common stock at a time to be selected by the preferred stockholder. Unless otherwise stated, this means such stock as may exist at the time of conversion. But the common stock available may be quite different in value from that existing when the convertible preferred was issued. Additional stock may have been issued, the stock may have been split up, a portion of the assets may have been distributed, a new prior-lien security issued, or other actions taken reducing the value of the common stock.

As protection against such actions, the contract usually provides that, in the event of any change affecting the value of the conversion privilege, offsetting adjustments must be made to prevent dilution of its value. For example, if an issue of preferred stock were convertible share for share into common and a 100 per cent stock dividend should be paid on the common, then the conversion ratio would be changed to two shares of common for one share of preferred.

PARTICIPATING PREFERRED

The exercise of the conversion option means that the preferred stockholder sacrifices his privileged position and assumes the role of common stockholder. With participating preferred stock, it is possible in a sense "to have the cake and eat it too," because the holder retains his original position and, at the same time, may receive dividends over and above the stated rate. The participation feature is almost always restricted to dividends, although it may be used in connection with the voluntary or involuntary liquidation of the assets.

Sharing of additional dividends may be on either of the following bases:[8]

1. *Unrestricted participation,* in which the participation would commence without necessarily waiting for the common stock to receive a stated amount.

2. *Restricted participation,* in which the receipt of extra dividends may be delayed or restricted in the following ways: (*a*) participation not to begin until the common stock has received an amount equal to the stated amount on the preferred, after which both classes of stock share equally; (*b*) same delay as provided in (*a*), but the participation is restricted to a fixed amount; (*c*) same delay as provided in (*a*), but the participation is restricted to a stated percentage of the extra distribution.

One well-known case of liberal participation involved the 7 per cent

[8] See *Moody's Industrial Manual, 1960,* p. a136, for list of securities with participation rights which are currently outstanding.

cumulative preferred stock of the Westinghouse Electric and Manufacturing Company. The stock had equal voting power per share with the common stock and received dividends on the same basis as the common as soon as the latter was paid 7 per cent. Dividends, either in cash or stock, in excess of this base rate were received on a number of occasions, the highest cash payment amounting to 5 per cent in 1937, while a stock dividend of 10 per cent had been distributed in 1924. With its noncallable feature, the stock appeared to have a permanent status; however, it was retired in 1946 when a revision of the capital structure was effected and the name of the company changed to the Westinghouse Electric Corporation.[9]

One of the few preferred stocks with unrestricted cumulative participation rights still outstanding is the 5 per cent original cumulative participating preferred of the Southern California Edison Company. Issued at the time of incorporation of this company in 1909, this stock is noncallable and has a preference over all other stock issues in the event of liquidation. The participating rights to dividends may be summarized as follows: (1) to the extent that dividends on other series of preferred stock exceed the rate on the subject issue, the differential is both participating and cumulative, and (2) there is further participation on a noncumulative basis with the common stock to the extent that the rate on the latter may exceed the highest rate on any preferred stock issue. As a result of the latter feature, dividends were paid on this stock at the rate of 8 per cent from 1950 to 1960.

The 6 per cent cumulative participating preferred stock of the Diamond Match Company is illustrative of restricted participation. Again, like the Westinghouse stock, it was not callable; but it, too, was retired (December, 1950) pursuant to a plan approved by the stockholders. Each share of preferred received, in exchange, one share of new $1.50 cumulative preferred with a par value of $25 plus three-tenths of a share of common stock. The earlier preferred stock had a regular dividend rate of $1.50 per year; and, when a similar amount was paid on the common, it participated share for share up to 8 per cent. Mention may also be made of the $3.00 no-par prior preferred stock of the Curtis Publishing Company, which is entitled to a further cumulative dividend of $1.00 to the extent earned; in this instance, the participation in earnings is not dependent upon the payment of dividends on the common stock. Extras on this stock have been paid annually from 1943 to 1960, the latest date of reporting available at this time.

One of the few examples of participation in the assets in the event of liquidation is the 8 per cent preferred stock of the Midland Steel Products Company, which was eliminated in February, 1930 under arrangements approved by the stockholders. In this instance, the preferred stock was entitled to be paid $110 per share plus 80 per cent of the remaining

[9] See p. 229.

assets. Its share in the distribution of earnings was also 80 per cent, after the common had been paid $4.00 for the current year. In the adjustment of the capital structure, each old preferred share received one share of new 8 per cent cumulative preferred and two shares of new common stock.

The right of participation is not a common feature and appears to be related to the purpose underlying the issuance of preferred stock. Stock that is issued to raise new capital is not likely to carry the participating provisions, whereas stock issued in connection with the reorganization of a company may have the privilege attached for "sweetening" purposes. In the latter case, participation in possible future gains makes the new security appear more attractive to those investors who are forced to accept a security of lower rank for their formerly "secured" holdings.

RESTRICTIONS ON ISSUANCE OF NEW SECURITIES

Inherent in most security issues is the question of relations between investors and management. At the time the securities are sold, there is a bargaining for position between the agency that will sell the securities and those who represent the corporation. The former naturally tries to add various special or "sweetening" features to make issues more salable, while the latter seek to avoid provisions that may impose an unnecessary burden. Both groups recognize that once the securities are outstanding, it is inevitable that management and investor interests will have a high degree of interdependency. When consideration is being given to the offering of preferred stock, selling and investment interests quite naturally stress various features that are intended to protect the future position of the stock. On the other hand, the imposition of too many restrictions may prove embarrassing to the management by unduly limiting its freedom of action. Most of the restraints are found in the establishment of controls over the sale of new security issues which would affect the position of the preferred stock.

As a case in point, it may be observed that the protective provisions covering the 5 per cent cumulative convertible preferred stock of the Goodyear Tire & Rubber Company, retired in 1954, restricted the creation of debt, as well as the issuance of any stock having equal or senior priority, unless approved by 66⅔ per cent of the preferred stockholders.[10] Requirements of this type are fairly common, particularly in the industrial area, where the use of bonds is not comparable to that which prevails in the public-utility and railroad fields. Approval by two-thirds of the preferred stock is the most common consent provision, although there are a number of instances where more or less than this majority may be required. Also, because of the familiar difficulties in obtaining a return of ballots, it is sometimes provided that action may be taken unless a certain

[10] The conversion privilege expired on October 1, 1946.

percentage of the preferred stockholders—usually one-fourth or one-third—objects.

Other controls on the issuance of additional securities may assume the form of required financial standards. For example, the amount of a new issue may be limited to a fixed percentage of the value of property acquired, such as 75 per cent. More frequently, the standards require adequate coverage of dividends and the maintenance of a liquid condition in the form of a percentage relationship between the net quick assets and the preferred stock.

VOTING RIGHTS

Preferred stock is a mixture of various privileges and rights obtained by the reservation of authority. Dividends are usually on a cumulative basis, the privilege of conversion may be found, and often the right is reserved to approve the issuance of new securities. Because of these conditions, the need for preferred stockholders to vote on all questions is not pronounced. Nevertheless, the majority of preferred stocks carries the right to vote in the event of failure to meet prescribed standards of operation.[11] One circumstance which gives cause for voting is the omission of dividends. Numerous issues provide for the assumption of the right to vote as soon as two consecutive dividends are passed, while others may require as many as four. Because of a minority position, voting power may prove to be of little value unless it provides for the right to elect a specified proportion of the directors. The cumulative preferred stock of General Motors Corporation is a case in point. This stock is entitled to elect one-fourth of the directors whenever the dividends are more than six months in arrears.

Industrial and public-utility issues usually provide limited voting rights, but the majority of the railroad issues have the voting privilege without restriction. Railroad preferred stocks are customarily noncumulative as to dividends and are not greatly removed from the common stock classification. Under the circumstances, it is fitting that railroad preferred and common stocks be given equal voting power. The peculiar character of railroad preferred stocks is largely the result of their origin—chiefly as a consequence of reorganization proceedings.

RATE OF DIVIDENDS

The key significance of the rate of dividends paid on preferred stock is found mainly in the yield on the capital investment. To investors, it

[11] In the period 1885–1934, a total of 1,094 listing applications was filed with the New York Stock Exchange. In an analysis of 966 of these issues, it was found that only 55, or 6 per cent, had no voting rights whatsoever; 277, or 29 per cent, had full voting rights; and 634, or 65 per cent, had voting rights under a variety of circumstances. Moreover, it is probable that the 128 unclassified issues carried full voting rights. See W. H. S. Stevens, "Voting Rights of Capital Stock and Shareholders," *Journal of Business*, Vol. XI (October, 1938), pp. 323–26.

reveals the return on their investment, while to the corporation, it is the measurement of the cost of money. How does preferred stock meet this test? It is not possible to give a dogmatic answer to this question, but a basis of evaluation may be established by comparing the average yield on outstanding high-grade preferred stocks with that on "triple A" rated bonds. The results for public utility companies may be seen in Table 6 for the years 1950 to 1959, which also reflects the background influence of the money market.

TABLE 6

AVERAGE ANNUAL YIELD ON OUTSTANDING PUBLIC UTILITY BONDS AND PREFERRED STOCK, 1950–59*

(Per Cent)

Year	Bonds	Preferred Stock
1950	2.55	3.79
1951	2.78	3.97
1952	2.88	3.96
1953	3.12	4.10
1954	2.82	3.88
1955	3.00	3.90
1956	3.30	4.13
1957	3.76	4.48
1958	3.61	4.34
1959	4.27	4.62

* *Moody's Manual of Public Utilities, 1960*, p. a23.

In studying the data contained in Table 6, it will be seen that the spread between the rates on bonds and preferred stock narrowed during the ten-year period. Moreover, it will be appreciated that the figures shown are averages and that a high-grade preferred stock of one company may sell at a more favorable rate than that on the bonds of another company. Currently, for example, the National Can Corporation debenture 5's, due in 1976, are selling at 94, while the 7 per cent cumulative preferred stock of the American Can Company is selling at a price which yields a return of 4.86 per cent. In 1955, the Bridgeport Brass Company issued by means of a public offering $10,127,350 cumulative convertible preferred stock at 4.50 per cent, while the Maine Central Railroad placed privately $1,700,000 first mortgage and collateral trust bonds, due in 1978, at 4⅞ per cent. However, for the same company, bonds will naturally sell at a lower rate than preferred stock.

VOLUME OF PREFERRED STOCK

Despite the fact that preferred stock is one of the two ownership elements in a corporation, it should be recognized that it is often used for purposes of financing not intended to be permanent. At least, there is a

tendency on the part of management to give more weight to it as a facility for raising funds than as an ownership factor. In spirit, it is likely that this same attitude applies to new financing by the use of common stock, in that financial advantages, as such, probably outweigh motivations arising out of ownership. In short, it may be said that, in many respects, management constitutes a separate identity of its own

TABLE 7

NEW PREFERRED AND COMMON STOCK OFFERINGS FOR CASH SALE IN THE UNITED STATES, 1934–60*

(000 Omitted)

Year	Preferred	Common
1934–39		
High	$ 405,955	$ 285,403
Low	6,272	19,490
1940–44		
High	369,471	163,173
Low	112,020	33,545
1945–49		
High	1,126,667	890,855
Low	424,662	397,364
1950	630,822	810,654
1951	837,656	1,212,494
1952	564,498	1,368,551
1953	488,564	1,326,013
1954	815,908	1,212,677
1955	635,058	2,185,228
1956	635,527	2,301,091
1957	410,504	2,516,160
1958	571,474	1,334,079
1959	531,191	2,027,109
1960 (Jan.–July)	219,823	1,109,669

* Securities and Exchange Commission, *Twenty-fifth Annual Report for the Fiscal Year Ended June 30, 1959*, p. 222, and *Statistical Bulletin*, September, 1960, p. 7.

and, as a result, may tend to view all media of financing purely as a means of carrying out its task of operations. In other words, financing has many of the features of a game between management and investors in which both parties naturally seek to take advantage of every favorable opportunity.

Some of this philosophy may be observed in Table 7 which reports common and preferred stock offerings for cash sale for selected years. In the years of prosperity and boom, full advantage is taken of the opportunity to sell common stock; in less favorable years, money-market conditions create an atmosphere which makes preferred stock relatively more acceptable. At the same time, as shown by Table 7, preferred stock is not used to raise funds in large volume. Consistent with its hybrid na-

ture, preferred stock has its greatest appeal to discriminating investors and may be said to have a selective market.

REASONS FOR ISSUING PREFERRED STOCK

Within limits, corporations have a choice of the type of securities that are issued to raise capital; and the query may be raised as to why preferred stocks would be selected as a medium. Since they entail a higher cost than bonds and often impose various restraints on the freedom of future financing, certain good reasons must exist to justify their use. The following appear to be cogent:

Necessity—a Substitute for Bonds. Financial conditions may preclude the issuance of high-grade bonds but may be satisfactory for the sale of preferred stock. For example, the earnings of a particular company may not be sufficiently stable to meet the fixed charges on bonds, but the average return may justify the use of preferred stock. Similarly, it is a convenient medium of satisfying junior bondholders' demands in reorganizing companies that have failed.

Protection of Control. Preferred stock is not only a convenient alternative for the raising of capital, but it may also be favored for reasons of control. As discussed earlier, preferred stock usually has limited voting rights but seldom has authority to vote on operating policies. By using stock of the preferred type, controlling interests may continue their positions without further investment.

Even when the preferred stock has voting power, ultimate protection to those in control may be assured if the stock is redeemable. A famous illustration of this influence of the callable feature is the fight between Hill and Harriman in 1901 for the control of the Northern Pacific Railway Company. The capital structure of the company at that time was composed of $80,000,000 of common stock and $75,000,000 of preferred stock. In the scramble for the controlling position, Hill obtained common stock to the extent of $42,000,000 and preferred stock to the extent of $29,000,000. Harriman had common stock amounting to $37,000,000 and preferred stock of $42,000,000. It will be seen that Harriman had a majority of the existing voting control. On the other hand, Hill had a majority of the common stock; and, since the preferred stock was redeemable, he simply started a rumor that it would be redeemed. By reason of his strategic position, Hill was able to reach his objective by ultimately co-operating with Harriman in the formation of a holding company which would exercise control.

Market Conditions and Investor Preference. Money-market conditions often make it desirable to float preferred stock in preference to either bonds or common stock. As is true of any marketing operation, it is essential to meet the varied demands of many types of buyers. The securities market is no exception, and preferred stock enjoys real popularity

in many quarters with respect to both individual and institutional investors. Under these conditions, corporations naturally take advantage of the opportunity to satisfy a recognized investment need.

MISCELLANEOUS TYPES OF PREFERRED STOCKS

Other terms are sometimes applied to stock issues which have the same qualities as preferred stock. One instance is the use of the term "debenture stock" by the General Motors Corporation. Originally, the company had outstanding 7 per cent and 6 per cent debenture stock issues. The 7 per cent issue was disposed of by exchanging it share for share for a new 7 per cent preferred stock, which was a part of the simplification program inaugurated in 1924. It was also hoped to eliminate the 6 per cent issue by offering one share of the new 7 per cent preferred for each share of the debenture stock plus $10. However, almost $2,000,000 of the 6 per cent debentures were not exchanged. Later, all of the preferred issues were consolidated successfully into no-par preferred stock bearing an annual dividend rate of $5.00. Curiously enough, the common stock bears a par value of $1.66⅔ per share, while the preferred is no-par.

In the same manner that common stock may be classified into A and B groupings, it is not uncommon to find a similar classification of preferred stocks. Reference is not made here to the fairly frequent use of such letters to designate different series of stock with the same basic rights but, as indicated, to stocks that do not have the same priority or other rights. Again, as indicated in the preceding chapter, there is good reason to regard many so-called "Class A common stocks" as part of the preferred category. In fact, there is so much overlapping of security issues that it is virtually impossible to establish any perfect classification.

So-called "prior-lien" stock is also a form of preferred security, achieving a position of priority by permission of the holders of other preferred stock issues which may be outstanding. On occasion, existing security holders may find it expedient to make such a sacrifice. When new financing is difficult and the outstanding security issues are in jeopardy, the sacrifice of priority of claim because of improved prospects may be sound policy.

Guaranteed stock is sometimes thought of as being a form of preferred stock. Technically, this is incorrect, since any class of stock may be guaranteed. Guaranteed stock is created whenever a corporation other than the issuing corporation guarantees the payment of the dividends upon an issue of stock. The guaranteeing corporation must pay the dividend or face receivership as insolvent. The stockholder is placed in the position of being a creditor of the guaranteeing corporation while retaining all his rights in the issuing corporation. The guaranty usually arises through the lease of corporate property in its entirety or as an aid from a parent corporation for the financing of a subsidiary.

FUTURE OUTLOOK

Preferred stock has many features making it peculiarly adaptable to the new financing order which seems to be evolving. In the future, it appears that the emphasis is to be upon stability of operation and employment and upon the avoidance of forced liquidation. Preferred stock may facilitate this objective because of the greater flexibility offered to financial management through such features as the absence of a fixed maturity date for the payment of principal, the power to defer dividends without serious consequences, and the ability to reorganize the capital structure to meet pronounced internal or external changes. Obviously, these rights may be abused by a management that lacks a proper conception of the public interest; but, when exercised judiciously, they may be of real benefit to both the corporation and the investors. The losses usually attendant upon forced liquidation or readjustment may be avoided, and business situations which might prove disastrous under bond financing can be successfully weathered.

QUESTIONS AND PROBLEMS

1. Discuss the hybrid nature of preferred stock and evaluate its appeal: (*a*) From a management point of view. (*b*) From an investment point of view.
2. Do you think that corporate terminology should reflect as nearly as possible the subject that is designated? Discuss the difficulties of assuring the objective.
3. Do you think that the no-par feature is as justifiable in the case of preferred stock as it is for common stock?
4. Consider the merits of noncumulative dividends from both the corporate and investor points of view.
5. The noncumulative preferred stock of Fruit-of-the-Loom, Inc., requires payment of dividends whenever earnings are equal to 115 per cent of the dividends but permits the withholding of one-third of the earnings to strengthen the financial position of the company. Discuss the merits of this plan.
6. Do you think that preferred stock should have full voting rights?
7. Refer to *Moody's Manual*, and note the protection against additional issues and other contingencies of the preferred stocks of the following companies: Kaiser Aluminum and Chemical Corporation; Public Service Company of Colorado; and the Southern Railway Company.
8. The $3.00 participating preference stock of the Standard Fruit and Steamship Company provides for participation in dividends beyond the stated rate up to four times the dividends paid on the common stock. Why would a company issue stock with such a liberal provision?
9. Evaluate the merits of including limited or full rights of dividend participation as a feature of preferred stock.
10. To liquidate the more than $19,000,000 accumulated dividends on preferred stock of the Western Maryland Railway, it was necessary to raise

the funds by bank loans and the sale of additional common stock. Evaluate the merits of this arrangement.

11. Dividends on the following two preferred stocks have been accumulating for more than ten years (as of early 1961): Reis (Robert) & Co., $1.25 cumulative prior preference stock, and Virginia-Carolina Chemical Corporation, 6 per cent cumulative participating preferred stock. Refer to *Moody's Industrial Manual*, and evaluate the conditions leading to the failure to meet the normal dividend requirements.
12. Select three cases of preferred stocks having the right of conversion, and show the price trend of these issues in comparison with that of common stocks.
13. Discuss the reasons for increasing the conversion price over a period of time. Do you favor stopping the right entirely after a specified number of years?
14. Appraise the merits of the call feature of preferred stocks in general; also, when used with convertible preferred stocks.
15. Evaluate the importance of preferred stock as a source of funds.
16. Comment on the differences in the yields on bonds and preferred stocks as shown in Table 6.
17. Discuss the observation on page 107 that "Preferred stock has many features making it peculiarly adaptable to the new financing order which seems to be evolving."

REFERENCES

BABSON, ROGER W. "The Case for Cumulative Preferred Stock," *Commercial and Financial Chronicle*, Vol. 189, No. 5818 (February 5, 1959), p. 8.

BERLE, A. A., JR. *Studies in the Law of Corporation Finance*. Chicago: Callaghan & Co., 1928.

BOGEN, J. I. (ed.). "Corporate Stock," *Financial Handbook*, pp. 436–440. New York: The Ronald Press Co., 1954.

BRADLEY, JOSEPH F. *Fundamentals of Corporation Finance*, chap. xii. New York: Rinehart & Co., Inc., 1959.

FERGUSSON, DONALD A. "Recent Developments in Preferred Stock Financing," *The Journal of Finance*, Vol. VII, No. 3 (September, 1952), pp. 447–62.

———. "Preferred Stock Valuation in Recapitalizations," *The Journal of Finance*, Vol. XIII, No. 1 (March, 1958), pp. 48–69.

FLETCHER, WILLIAM MEADE. *Cyclopedia of the Law of Private Corporations*, Vol. 11. Rev. and permanent ed. Chicago: Callaghan & Co., 1932.

RODKEY, R. G. *Preferred Stocks as Long-Term Investments*. Ann Arbor: School of Business Administration, University of Michigan, 1932.

Statistics of American Listed Corporations (A Work Projects Administration Study Sponsored by the Securities and Exchange Commission, 1940), Part I, pp. 21–23, and supporting tables.

STEVENS, W. H. S. "Rights of Non-cumulative Preferred Stockholders," *Columbia Law Review*, Vol. XXXIV (1934), pp. 1439–61.

Chapter 7

BONDS IN GENERAL

CORPORATIONS HAVE two familiar, major external sources of capital—ownership and credit. The former is represented by the types of stock discussed in the previous two chapters, whereas the latter takes the form of borrowed funds which create an obligation on the part of the corporation in favor of the lender. The two familiar categories of proprietorship and liabilities, in accounting and financial parlance, are thereby created. The second class of financial interest is made possible in large measure by the existence of the underlying investment of the stockholders.[1] It would be impossible to borrow if it were not for the presence of the safety factor provided by the ownership base. Money may be borrowed only by having such a sustaining basis as evidence of permanence and good faith. Our particular interest at this time is the long-term type of credit which is represented by bonds.

THE NATURE OF A BOND

In formal, legal terminology, a bond is a promissory note under seal. However, in the more familiar language of the street, it has been common to use the word "bond" to mean a long-term debt obligation, and particularly one issued to the general public.[2] On the other hand, the term "note" has meant an obligation with a comparatively short maturity and a limited number of holders. Generally, in a note, the terms and provisions of the debt have been set forth in the document itself; in a bond, they have always been found in a separate instrument known as an "indenture." But, beginning in recent years, there has been a tendency

---

[1] There are exceptions arising out of special circumstances. For example, the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation retired all their stock but continue to operate in corporate form as instrumentalities of the federal government.

[2] The following terms are generally descriptive of obligations issued by the United States Government: "bills," maturities up to one year; "certificates of indebtedness," generally with maturities of one year; "notes," with maturities of one to five years; and "bonds," with maturities of over five years. "Bills" are sold on a discount basis, and all other forms of securities are interest bearing.

to use the terms "note" and "bond" interchangeably; and there is need to rely upon context instead of arbitrary definition. To observe this random use of terminology, reference may be made to the accompanying illustrations and comments:

Long-term notes sold publicly—although long-term obligations that are distributed to the public almost always bear the title "bonds," an illustration to the contrary is the New Bedford Gas and Edison Light Company 2⅞ per cent notes, due in 1975, sold in October, 1950.

Long-term notes sold privately—there is now widespread use of the word "notes" to designate issues that are placed privately, e.g.: 3¾ per cent promissory notes of the Chrysler Corporation, due in 2054, and issued in 1954; and the 3¾ per cent promissory notes of the Union Carbide and Carbon Corporation issued in the same year with a maturity of 2051.

Short-term bonds sold publicly—while the designation "notes" is generally used for short-term issues sold either publicly or privately, an example of a short-term bond sold publicly is the Federal Home Loan Bank 1¼ per cent bonds, due on April 15, 1948, issued on October 15, 1946.

We shall employ the term "bond" generally when speaking of long-term obligations, but the reader should be aware of the variations in its usage in actual practice. The more prominent features of a bond may be listed as follows:

1. A definite promise to pay, as to principal amount.
2. A definite promise to pay, as to interest.
3. A definite life.[3]
4. A statement of the tender or medium of payment.
5. The place of payment.
6. Reference to the bond indenture for other rights and powers, such as limitations upon the issuance of additional securities, curtailment of management prerogatives in the event of failure to meet prescribed conditions, action in the event of default of interest or principal payments, etc.

THE NEED FOR A TRUSTEE

If bonds are sold to the public at large, as distinguished from direct placement with one or a few investors, the number of bondholders may be very large and widely scattered. Under these conditions, it is not practical to deal with each of them individually; and the corporation appoints a third party as a trustee to represent the bondholders.[4] The primary function of the trustee who holds the copy of the bond indenture, or contract between the borrowing company and the bondholders, is to enforce the rights and interests of the bondholders to the extent authorized in the bond indenture.

Although the trustee is the agent of the bondholders, he is appointed

[3] Occasionally, a bond is found which has no maturity date, i.e., a perpetual bond.

[4] Securities sold privately to one or a few investors may also have a trustee, to obtain the benefit of his specialized skill in handling the related duties and to anticipate possible later resale to the public.

by the corporation before any of the bonds are sold, and without consulting the bondholders. Legally, any competent person may serve as trustee; but usually, a trust company is appointed to discharge most of the duties. A corporate trustee has the advantage of continued life and the efficiencies that come with a specialized occupation. However, it is customary to appoint a natural person in addition to the corporate trustee. This dual trusteeship makes it possible to meet the requirements of those states in which the corporate trustee is unable to act for the bondholders. The trustee may be changed from time to time in the event of death or resignation, in keeping with provisions included in the underlying indenture.

The duties of the trustee are quite numerous, among the more important of which are the following:

Certification of the Securities Issued. The signed statement of the trustee appears on the bond proper and is intended to prevent issuance in excess of the amount of securities formally authorized. However, the certification is not a guaranty of the legal validity of the bond issue.

Checking of Performance. The trustee is usually required to examine the company's property and accounts from time to time to see that they meet the terms of the mortgage or indenture. He must also check the existence of proper insurance, payment of taxes, etc.

Action in Default. In the event of default in interest or principal payments, the trustee is expected to notify the bondholders and to take proper action against the mortgagor.

Fundamentally, the trustee assumes an obligation to act as if he were the sole owner of all bonds. His appointment is made by the corporation, but his responsibility is to the bondholders. The trustee receives compensation from the corporation solely for reasons of convenience, and no effect upon his line of authority is intended. Also, it is probable that the bondholders pay the fee ultimately in the form of lower interest rates.

THE INDENTURE

One of the most important instruments relating to corporate financing is the indenture.[5] Briefly, an indenture is a contract or an agreement between the company, the trustee, and the bondholders which covers the terms and conditions pertaining to a bond issue. It is usually called a "mortgage indenture" when used in connection with securities supported by a mortgage; when used with unsecured obligations, it is generally known as a "trust indenture," "corporate indenture," or "trust agree-

[5] The word "indenture" stems from early times when agreements were written twice on a page in the original, after which the page was torn and the separate pieces given to the parties involved. If the indentations of the tear matched, validity of the agreement was established.

ment." Besides including the duties of the trustee, which were previously described, it contains complete provisions having a bearing upon the bond issue. As a result, the indenture is commonly as large as a book,[6] as may be seen from the following summary of its contents:[7]

1. Preliminary recitals of the parties; authorization of the bonds; and the form of the bonds, interest coupons, registration, and trustee's certificate.
2. Statement of the mortgage or deed of trust with a detailed description of the property security.
3. Covenants of the company issuing the bonds to pay the principal and interest when due; to carry insurance and pay taxes; and usually to protect the bonds with such provisions as limitation of additional security issues according to the terms of the indenture, limitation on dividends on common stock in the event of failure to meet prescribed standards, etc.
4. Provisions covering the sinking fund and the redemption of the bonds.
5. Definition of default and provisions for action by the trustee in this event.
6. Statement of the duties of the trustee.
7. Miscellaneous provisions covering supplemental indentures, status of the bonds in the event of merger or consolidation, bondholders' meetings, etc.

Because of the basic nature of the indenture, its drafting must be done with meticulous care. The terms and conditions of performance cover a long span of years, and it is vital to provide for all contingencies as well as to establish common understanding among the participating parties. When securities are privately placed with one or a small number of lenders, the task is simpler and the functions of the indenture may be performed by a loan agreement. In this case, there is opportunity for direct dealings between the lender and the borrower although, even here, it is not unusual for investment banking firms to serve as negotiators and thereby inject their specialized knowledge of money-market conditions and their experience with a variety of similar transactions. An example is the private placement in 1955 of the 3¾ per cent promissory notes of the Pan American World Airways, Inc., where two prominent investment banking firms served as negotiator. Among other things, arrangements were made for the immediate advance of funds in the amount of $25,200,000 and for an additional $34,800,000 on or prior to July 1, 1956. Provision is made for an annual sinking fund from 1966 to 1980 to establish an orderly basis for the retirement of the debt; however, there is a proviso that, with the consent of the noteholder, the sinking fund payments may be scheduled to a date not later than March 1, 1995.

When there is a public offering, the investors who fulfill the lending function are not yet known, and there is no opportunity for direct negotiations between the lender and the borrower. However, investment

[6] Few indentures have less than 100 pages.

[7] Based upon actual indentures reviewed and *Suggested Provisions for Corporate Mortgages and Indentures under the Trust Indenture Act* (New York: Commerce Clearing House, 1940).

bankers usually buy or guarantee the disposal of such issues, thereby putting their own profit-and-loss account at stake. To accept the security offering, the investment banker must be assured that it will have market appeal with respect to margin of safety, rate of return, and other miscellaneous features. At the same time, corporate officials must be equally alert in protecting their own interests. Among other things, they must satisfy themselves that the cost of money is consistent with their earning capacity as well as with money-market conditions, and must further give careful consideration to the restraints and restrictions placed upon the corporation. To reconcile the interests of the various parties, representatives of the selling or underwriting firm meet with the proper officials of the issuing corporation in order to reach a common understanding. Most of the results are given formal expression in the indenture.

TRUST INDENTURE ACT OF 1939

The underlying basis for the standards or requirements covering indentures is found in the Trust Indenture Act of 1939.[8] The act states that the national public interest and the interest of investors are adversely affected under the following circumstances:

1. When the obligor fails to provide a trustee to protect and enforce the rights and to represent the interests of such investors. . . .
2. When the trustee does not have adequate rights and powers, or adequate duties and responsibilities, in connection with matters relating to the protection and enforcement of the rights of such investors. . . .
3. When the trustee does not have resources commensurate with its responsibilities, or has any relationship to or connection with the obligor or any underwriter of any securities of the obligor. . . .
4. When the obligor is not obligated to furnish to the trustee under the indenture and to such investors adequate current information as to its financial conditions. . . .
5. When the indenture contains provisions which are misleading or deceptive, or when full and fair disclosure is not made to prospective investors of the effect of important indenture provisions; or
6. When by reason of the fact that trust indentures are commonly prepared by the obligor or underwriter in advance of the public offering of the securities to be issued thereunder, such investors are unable to participate in the preparation thereof, and, by reason of their lack of understanding of the situation, such investors would in any event be unable to procure the correction of the defects enumerated in this subsection.

As a correction for these evils, the law requires an "application for qualification" which must be filed with the Securities and Exchange Commission for each indenture covering securities to be sold in interstate commerce. If the application is not rejected or called for hearing and amendment within twenty days, it becomes effective. The law is applicable, of course, only to public offerings; during the fiscal year

[8] 53 United States Statutes at Large 1149–77.

ended June 30, 1959, the Commission approved 192 indentures involving issues in the amount of $4,229,058,500.

QUALIFICATIONS AND DUTIES OF TRUSTEE

To be accepted by the Securities and Exchange Commission, the indenture covered in the application must provide for a corporate trustee having adequate capital, with sufficient rights, powers, duties, and obligations to protect the investors adequately. Indicative of the requirements, neither the trustee corporation nor its officers or directors may have any interest, direct or indirect, in the obligor corporation. Likewise, no director or officer of the obligor may have any interest in the trustee. However, one individual may be an officer of the trustee corporation and a director of the obligor corporation, or vice versa; but he may not be an officer in both corporations. If the trustee has more than nine directors, this exemption may be applied to an additional member.

Again, to avoid harmful conflicting interests, the trustee may not own more than 5 per cent of the voting securities of the obligor and may not control as much as 25 per cent of such securities through its capacity as trustee, guardian, or administrator of estates or funds. The obligor corporation may not own more than 10 per cent of the voting securities of the trustee. In other words, the trustee must be free of any influence tending to create bias either for or against the obligor corporation. The act intends that the trustee shall take all steps necessary to protect the investors. The trustee must be empowered to act as if it owned the securities involved, and it must be obligated to take the steps that the actual owners would take both before and after default. To this end, the trustee must keep sufficiently well informed of the company's condition to have some forewarning of impending defaults and to take any steps possible to protect the security holders' interest.

In addition, the indenture must require the trustee to make reports to the security holders at intervals of not more than twelve months. Such reports must contain information relating to the continued eligibility of the trustee, the property or funds in the possession of the trustee, any substitution or change in the property under the lien, any additional securities issued under the indenture since the last report, and any material steps taken to carry out its duties under the indenture during the report period. The report is to be transmitted to all registered holders of indenture securities and to all others who have filed their names and addresses with the trustee.

AN EXAMPLE OF A TRUSTEE'S REPORT

The reports of the trustee are sent regularly to the bondholders, and a copy of each report is forwarded to the Securities and Exchange Com-

mission. Supervision by the latter, as well as contractual obligation, provides little opportunity to avoid this duty. At the same time, it should be noted that the reports are not lengthy, being intended mainly to assure compliance with the terms and conditions of the indenture. To visualize their nature, the following may be offered as an example:

ANNUAL REPORT NO. 3

To the Holders of Upper Peninsula Power Company First Mortgage Bonds, 3¼% Series due 1977, and First Mortgage Bonds, 4% Series due 1978, issued under Indenture of Mortgage dated as of May 1, 1947, as supplemented, from said Company to City National Bank and Trust Company of Chicago, as Trustee:

The above-mentioned Indenture requires the undersigned, as Trustee thereunder, to transmit an annual report to you with respect to various matters relating to the trust.

Accordingly, you are informed that to the best of its knowledge, City National Bank and Trust Company of Chicago continues to be eligible and qualified under the Indenture to act as Trustee.

As of January 30, 1950, there were no advances made by the Trustee remaining unpaid, no indebtedness of the character required by said Indenture to be reported was owing by the Company to the Trustee individually, nor were there any properties or funds physically in its possession as such Trustee.

No release of any of the mortgaged property was made during the year ended January 30, 1950.

No additional bonds of any series were issued during the year under review. However, $4,000 par value of the First Mortgage Bonds, 4% Series due 1978, were in 1949 surrendered by the Company to the Trustee for cancellation in satisfaction of the annual sinking fund obligation so that as of the date of this report $3,430,000 par value First Mortgage Bonds, 3¼% Series due 1977, and $396,000 par value First Mortgage Bonds, 4% Series due 1978, remained outstanding

Dated at Chicago, Illinois, as of January 30, 1950.

CITY NATIONAL BANK AND TRUST
COMPANY OF CHICAGO,
Trustee as aforesaid

REGULATION OF TRUSTEES—A RECOGNITION OF PUBLIC RIGHTS

The increasing control and regulation of trusteeship is just another straw in the wind pointing to the increased recognition which is being given to the consolidated rights of individual investors and of the public generally. Previously, the contract between the obligor and the trustee was deemed to be of special interest only, and the adequacy of its protective provisions was left almost entirely to the supposed judgment of the investors. Not only did such discretion appear to be consistent with the accepted doctrine of *caveat emptor*, but in addition the scattered distribution of investment holdings made it difficult for the investors to exercise concerted action in their dealings with the trustee.

Today, the impotency of individual action is recognized, and the rights of investors as a whole are cast into a form of public responsibility.

Government has considered it both a prerogative and a duty to act in behalf of the group. The legislation providing standards for trusteeship is an example of this exercise of responsibility by government, and numerous other instances will be discussed at various other points in this volume. In essence, the sanctity and inviolability of individual contracts are still recognized; but agreements having an effect upon groups or large sections of the public are believed to affect the public interest. The validity of this distinction may be debated; but at this point, our concern is not so much with its merits as with recognizing the realities of present financial practice. In any event, the trustee must be aware of his duties in order to avoid charges of negligence.

REGISTERED BONDS

Registered bonds obtain their name from the fact that the owners are recorded in the proper corporate records which are maintained by the issuing corporation or by a transfer agent. The interest is mailed to these listed holders on interest dates. This type of bond is not as readily transferable as the coupon bond, but it has the advantage of protecting the owner in the event of its loss. The owner will continue to receive interest and may in time secure a duplicate of the lost bond. A registered bond has limited negotiability in the sense that the owner may endorse it over to any purchaser without the company's permission. Upon acquisition, however, the bond must be sent to the corporation or its agent for cancellation and for issuance of a new bond, which is registered in the name of the new owner.

COUPON BONDS

Coupon bonds derive their names from the coupons that are attached to the bond certificate, one coupon for each interest payment due during the life of the bond. On interest dates, the holder of the bond clips the coupon and remits it for payment. Collection may be made through a bank in much the same way as checks and notes are placed on deposit. Coupon bonds are transferable by mere delivery, and the holder is the legal owner unless it can be shown that possession was obtained through illegal means. Because of this ready transferability of title, the owner should notify the corporation immediately in the event of loss by theft or misplacement.[9] Otherwise, remittance will be made to the person

[9] To quote a simple indenture provision: "In case of destruction or loss, the applicant for a substituted bond shall furnish to the Company and the Trustee evidence of the destruction and loss of such Bond and its coupons, and of ownership thereof, and indemnity satisfactory to the Company and to the Trustee." Although the cost of such an indemnity is only $10, there may be considerable inconvenience in furnishing evidence of loss.

presenting the bond coupon or certificate. Since the corporation has no record of the owners of these bonds, the chief method of communication with the bondholders is through some form of advertising, usually in the financial pages of newspapers such as the *New York Times* or the *Wall Street Journal.*

COMBINATION OF REGISTERED AND COUPON BONDS

Making bonds available in either coupon or registered form is mainly for the purpose of accommodating investor needs. The registered feature is favored for long-term holding, while the quick transferability of coupon bonds lends itself to temporary investment. An attempt to provide the advantages of both is found in registering the principal while having the interest payments on a coupon basis. To a considerable degree, the combined facility may defeat its own purposes. Unless one derives great pleasure from clipping coupons, interest collected by this means is less convenient than having it mailed directly by the corporation or its agent. On the other hand, if ready transferability is desirable, the coupon bond is superior to the registered type. In the event of sale, the combination bond would necessitate the issuance of a new certificate, whereas a straight coupon bond could be transferred by delivery.

The registration feature also has a minor effect on the price of a bond. Both the fully registered and the registered-coupon bonds entail an expense of transfer which causes them to sell at a slightly lower price than the coupon type. In addition, registered bonds are usually held for a long term and seldom appear in the market for trading. On the other hand, coupon bonds have a regular turnover to meet the needs of various investing groups, such as banks, investment trusts, and individual investors. This market activity, combined with the larger amount outstanding, tends to give an advantage to coupon issues.

BOND DENOMINATION

Originally, the almost universal denomination of bonds in this country was $1,000 or some multiple of $1,000. Standardization of this bond unit was more pronounced than the $100 par was typical of stock issues. Within the past several decades, bonds of smaller denominations, such as $500, $100, $50, or even $25, have made their appearance; those with denominations of $100 or less are sometimes known as "baby bonds." Smaller denominations achieved greater recognition largely because of their use in federal government financing. Not only do such bonds provide a convenient medium for small investors but, also, they constitute a diversified and relatively stable source of funds for the government.

Private business has generally recognized the merit of tapping the small-investor market for the sale of stock, but it has not promoted

vigorously this source in the floating of bond issues. Small-denomination bonds are relatively scarce, and the question might be raised whether corporations are not missing a good source of capital in their failure to develop the middle-class investor field to a greater degree. The expanding number of stockholders in the larger companies, their small average holdings, and the volume of odd-lot transactions on the stock exchange all indicate the interest of the small investors, as well as the large amounts of funds which may be provided. The cost of distributing bonds in this manner would obviously be higher than sale in larger lots; but, at the same time, there would be many offsetting benefits, particularly in the form of increased public interest and support.

CLASSIFICATION OF BONDS

It is virtually impossible to design a rigid or entirely satisfactory classification of bonds. Most issues combine so many different features that they may belong in more than one division of any classification which might be established. Although rigid classification is impossible, tentative groupings may be presented as an aid to further study. The following is a summarized version of a bond classification which has been widely used:[10]

I. According to the character of the issuing corporation
   A. Civil loans—federal, state, municipal, etc.
   B. Corporate loans—railroads, public utilities, industrials
II. According to the character of the security of the bonds
   A. Unsecured—debenture bonds, income bonds, receivers' certificates, convertible bonds, short-term notes
   B. Secured or "re-enforced"
      1. Nonproperty security—assumed, guaranteed, joint bonds
      2. Property security
         a) Personal property—collateral trust, equipment trust, sinking fund bonds
         b) Real property—first-mortgage, general mortgage, consolidated mortgage, first and refunding mortgage, first and consolidated mortgage bonds
III. According to the purpose of the issue
   A. Civil—drainage, school, street, etc.
   B. Corporation—improvement, refunding, purchase of equipment or plant, consolidation, etc.
IV. According to payment of interest and principal
   A. Payment of interest—registered, coupon, contingent, etc.
   B. Payment of principal—serial, sinking fund, maturity, etc.

The portions of the classification applicable to this book may be mentioned briefly. In the first class, analysis will be limited to the subject of corporate loans. The second classification will be explained more fully

---

[10] Adapted from L. Chamberlain and G. W. Edwards, *The Principles of Bond Investment* (New York: Henry Holt & Co., 1927).

in the next three chapters describing bonds secured by real property, bonds secured by personal property, and the various forms of unsecured bonds. The third classification is a useful one but does not involve any serious problems of analysis. It is sufficient to say that the life of a bond issue and its terms should be consistent with its purpose. For example, an equipment obligation should certainly mature within the limits of the life of the equipment purchased; and, in the same way, securities issued to finance permanent improvements should ordinarily be long term rather than short term in nature.

The fundamental feature underlying the fourth classification is applicable to all of the others. Since the effect of the registered and coupon features upon the payment of interest has been discussed, it is pertinent that consideration be given to the payment of the bonds according to principal. In the first place, few bonds are issued on a perpetual basis. To date, the omission of a fixed maturity has been confined largely to certain foreign government issues, such as the British consols and the French *rentes*, as well as bonds of foreign business corporations. While rare, such bonds are not unknown in American practice. The Lehigh Valley Railroad's irredeemable, consolidated 6's are a case in point; but, under a debt adjustment plan in 1949, the perpetual feature was eliminated in favor of a fixed maturity—April 1, 1989. Another example is the former 6 per cent interest-bearing certificates of the Public Service Corporation of New Jersey, retired in 1948 as a result of the dissolution of the company. Prior to that time, the company did create a sinking fund for the purpose of liquidating the certificates by purchase in the open market.

SINKING FUND RETIREMENT

Under a sinking fund arrangement, the corporation sets aside each year an amount that is sufficient to retire the bonds by their maturity date. In doing this, a related purpose of maintaining or improving the ratio of the value of the underlying property security to the outstanding debt is served. Indeed, in the public-utility field, it is not uncommon to permit deduction from the required annual sinking fund payments of an amount equal to a declared percentage (often 60 per cent) of the net property additions. In such instances, the funds are sometimes designated as "improvement funds." Also, indentures may provide that the sinking fund payments may not begin until a number of years after the date of the indenture; or a lower payment may exist in the early years and be increased later.

Ordinarily, payments are made to the trustee (in keeping with the indenture described earlier) and may be in the form of cash or its equivalent in principal value of the subject bonds which have been purchased in the open market. Generally, the indenture gives the company the

right to use whichever of these two methods of payment it may prefer. Typical language in the indenture is as follows: "The Company will covenant . . . to pay to the Trustee as a Sinking Fund . . . cash in an amount equal to 1% of the aggregate principal amount," and "there shall be credited against the amount of cash so required . . . the principal amount of any . . . notes purchased by the Company and delivered to the Trustee for cancellation . . ."[11]

The amount of annual payment to the sinking fund is usually based upon regular and systematic retirement of the bonds by maturity; but, on occasion, it may be modified to allow for conditions of risk or contingency. Under the latter circumstances, a provision is included in the indenture to allow the trustee to accept less than a stipulated amount or fixed percentage of principal. Illustrative of this practice is the following statement:

> The Company covenants that . . . it will pay to the Trustee, as a Sinking Fund for the Bonds, an amount equal to the greater of (1) $100,000, or (2) 25% of the net income of the Company . . . provided that if the net income of the Company . . . shall be less than $100,000, the Sinking Fund payment due . . . may, at the option of the Company, be decreased by the amount of such deficiency in income, in which event the amount of such deficiency shall accumulate as a Sinking Fund obligation and be carried forward and shall be paid by the Company out of the first available net income . . . earned in subsequent fiscal years.[12]

As between payment in cash or in the equivalent purchase of the principal amount of bonds, the latter is naturally preferred by a corporation whenever bonds may be acquired in the open market at less than the redemption price. Indentures may give the right to anticipate future sinking fund payments, but they give the option to the corporation to withdraw funds to the extent that bonds are substituted for cancellation. Trustees may also act as the agent of the company to buy the bonds, although it is not uncommon to have another financial agent act in this capacity. Once the bonds are canceled for the sinking fund, they may not be reissued.

From the viewpoint of the investor, the practice of buying bonds in the open market for the sinking fund provides some benefit in its support of the price at which the bonds may sell. At the same time, its cumulative effects may weaken the marketability because of the progressive reduction in the amount of bonds outstanding. When the corporation is unable to buy bonds at the price fixed for redemption, or less, there is a drawing of bond numbers for the purpose of issuing a formal notice of redemption at the price stipulated in the indenture.

---

[11] *Prospectus*, New Bedford Gas and Edison Light Company, October 6, 1950, p. 25.

[12] *Indenture, First (Closed) Mortgage 5% Refunding Bonds*, Interstate Bakeries Corporation, June 1, 1943, pp. 26–27.

SERIAL BONDS

Under the serial plan, a bond issue is made up of a series of recurring annual maturities which may be of varying amounts. Such issues have considerable appeal from an investment point of view, offering a wide choice of maturity dates and facilitating the planning of an investment program. In addition, the diversified tastes of short- and long-term investors are more easily met. Viewed through the eyes of corporate management, the benefits are not nearly so apparent. Despite the investment advantages, as well as the avoidance of a premium when retiring the bonds, there is a marked disposition to avoid the rigid and binding schedule of debt amortization. It is also contended that the marketability is adversely affected, or at least complicated, because the serial maturity necessitates the fixing of a range of prices in order to accommodate the different maturities.

The use of serial bonds varies according to fields of activity and, to some extent, according to the financial standing of the corporation. Serial maturities are commonly used for equipment financing, as we shall discuss more fully in Chapter 9; here, we may simply note the 4¾ per cent equipment trust certificates issued in late 1960 by ACF Industries, Inc. Of the aggregate amount of $4,710,000, there is provision for annual equal repayments in amounts sufficient to retire $3,075,000 from 1961 to 1975; the balance of $1,635,000 is not due until 1980 and is not callable before November 1, 1970. This "balloon" feature is also found in the 3½ per cent secured serial notes issued in 1955 by the Baltimore and Ohio Railroad Company in 1955. Annual payments of $2,000,000 are due from 1956 to 1964, and a final payment of $17,000,000 is due at maturity in 1965.

Serial maturities are not uncommon in the private placement of loans because the direct negotiation facilitates a more varied arrangement of the terms and conditions. However, except for equipment financing, there is only limited use of serial maturities in the case of other public offerings. One of the few examples of the latter is the financing effected by United Industries Co., Inc., which also occurred in late 1960; specifically, it offered $500,000 convertible subordinate debenture 6's, due serially from 1965 to 1970. The offering price to the public was 100, of which the company would receive 95; the difference, of course, represents the commission to the selling medium.

As a side observation, it should be noted that serial retirement is a common characteristic of municipal financing irrespective of the maturity. In this instance, amortization is facilitated by the certainty of taxes and is encouraged as a means of restraining excessive use of the public debt.

NO FIXED PROVISION FOR RETIREMENT

Some bonds provide no specific means for their liquidation, even though they are not perpetual as to life. Under these conditions, the cor-

poration is called upon to take proper care of the issue when it matures, or at some earlier date. Often the problem is solved by refunding, which means that a new issue is prepared and offered either to the public or to the old bondholders. Of course, the present holders have the privilege of demanding cash; in this event, the new bonds are sold to other investors and the necessary funds raised. The annual volume of retirement of corporate bonds and notes is considerable as may be seen in Table 8

TABLE 8

NET CHANGE IN CORPORATE BONDS AND NOTES OUTSTANDING, 1940 TO 1959*

(000,000 Omitted)

Year	New Issues	Retirements	Net Change
1940	$2,477	$2,814	$ −337
1945	4,924	5,996	−1,072
1950	4,806	2,802	2,004
1955	7,571	3,383	4,188
1956	7,934	3,203	4,731
1957	9,638	2,584	7,053
1958	9,673	3,817	5,856
1959	7,150	2,891	4,259

* *Statistical Abstract of the United States, 1960* (Washington, D.C.: U.S. Department of Commerce, Bureau of the Census), p. 466.

which, to give perspective, also reports the new issues. The relationship between new financing and retirement is affected by a number of factors. Under an expanding economy the former should naturally exceed the latter, but, in periods of adversity, the reverse is likely to be true. Table 8 clearly reflects the impact of the high level of business activity in the late fifties and gives a clue to the retardation of private activity during the war period. Less evident are the indirect effects of money rates, the exercise of the option to convert bonds into stock, etc.

CALLABILITY

A refunding program is facilitated if the old bond issue is callable, that is, if the corporation has the right to call the bonds for redemption prior to the maturity date. The majority of bonds outstanding have the call privilege attached. Because of the inconvenience that investors may suffer by early redemption, a premium must usually be paid by the corporation upon calling the bonds. At the same time, this slight penalty is usually a minor item in comparison with the gains that may be realized by floating new securities under favorable conditions.

Parenthetically, it should be noted that the redemption of bonds for refunding differs in purpose from its use in connection with a sinking fund. The former is an act initiated by management mainly to effect economies

and improvement in financial arrangement, while the latter is a compulsory act under the indenture. In turn, it is not surprising that a difference in the redemption prices should appear according to these two purposes. The accompanying data show the redemption prices of the first-mortgage, 3¼ per cent series bonds, due in 1977, of the Upper Peninsula Power Company for selected dates:[13]

Year	Redemption Price for Refunding	Redemption Price for Sinking Fund Call
1947	$106.40	$102.95
1948	106.20	102.90
1949	106.00	102.80
1950	105.75	102.75
1960	103.55	102.00
1970	101.35	100.95
1976	100.15	100.15

A large majority of the industrial and public-utility issues carry the call privilege,[14] but railroad issues feature this provision in only a little over one-half of the outstanding issues. However, detailed study of the railroad securities shows that the noncallable bonds were issued largely during the latter part of the preceding century. More recent issues quite generally include the call privilege.

A frequent motivation underlying the use of the call privilege is the need to substitute permanent arrangements for the temporary financing of expansion. When doing this, it is common to float a security issue which is large enough to cover this purpose and also to refund an existing obligation bearing a higher rate. By this means, it is possible to consolidate the debt as well as to effect economies in the cost of money. For example, in the advertising of one bond issue, it was stated that:

> . . . the proceeds from the sale of these bonds will be applied chiefly to the retirement of the entire outstanding indebtedness of the Corporation and its constituent Companies (except $3,150,000 first mortgage indebtedness of . . . Company), and to the discharge of current obligations incurred in connection with the extensive construction program, now substantially completed, and the recent acquisition of .... Corporation.

Replacing an existing bond issue with a new one bearing a lower rate of interest is a method of effecting considerable savings. Even a difference of one-half of one per cent can accumulate to a sizable sum over a period of time; for example, on a $50,000,000 issue with a life of 20 years, it would amount to $5,000,000. To cite a concrete case, the Standard

[13] *Prospectus*, Upper Peninsula Power Company, May 1, 1947, p. 1.

[14] A study of 230 issues registered with the Securities and Exchange Commission from 1937 to 1940 showed that 96.5 per cent contained the redemption provision. See Securities and Exchange Commission, *Release No. 568* ("Statistical Series"), May 29, 1941, p. 5.

Oil Company of New Jersey called its debenture 3's, due in 1961, and replaced them with new debentures paying 2⅜ per cent, due in 1971. While the new bonds were offered at 98 (ranged from a low of 78⅝ to a high of 86¼ in 1960), there was a clear advantage to the company both as to the cost of the money and the maturity.

TABLE 9

TOTAL DOMESTIC CORPORATE BONDS CALLED FOR REDEMPTION PRIOR TO MATURITY DATES, 1927–60*

(000 Omitted)

Year	Industrial	Public Utility	Railroad	Total
1927	$419,334	$ 710,484	$ 128,143	$1,257,961
1929	688,091	138,932	4,086	831,819
1931	95,565	592,703	10,360	698,628
1933	116,846	37,582	674	155,102
1935	977,850	1,030,798	156,696	2,165,344
1937	460,689	1,119,477	161,046	1,741,212
1939	545,493	1,224,904	39,570	1,809,967
1941	483,287	1,283,657	142,436	1,909,380
1942	240,657	389,756	67,637	698,050
1943	250,790	447,167	220,202	918,159
1944	578,591	1,275,397	238,770	2,092,758
1945	790,360	2,120,870	1,334,943	4,246,173
1946	921,232	1,172,483	811,413	2,905,128
1947	138,759	756,794	126,078	1,021,631
1948	51,713	115,387	11,164	178,264
1949	73,556	241,297	19,802	334,655
1950	208,325	820,038	141,090	1,169,453
1951	108,979	114,425	67,287	290,691
1952	93,595	68,587	115,525	277,707
1953	30,173	31,753	30,509	92,435
1954	148,904	706,266	242,383	1,097,553
1955	307,315	417,125	134,139	858,579
1956	189,576	33,014	238,558	461,148
1957	61,895	11,671	820	74,386
1958	74,493	263,965	2,592	341,050
1959	137,465	40,122	1,016	178,593
1960	89,733	98,780	5,874	194,387

* Compiled from data published in the *New York Times*.

Other examples show that the savings may be more substantial than in the case just cited. Among the many bond-refunding operations carried out in recent years, the case of the B. F. Goodrich Company is particularly interesting. Calling its first 4¼'s in the amount of $21,049,000 and its first 3's amounting to $4,700,000, it was able to float a single new issue —its first 2¾'s, due in 1965. Even though the company received only 98¾ as compared with the public offering price of 100½, once again

there was a saving in the interest costs, an extension of the maturity, and a simplification of the financial program.

Callability may also be put into effect through agreement with the bondholders. This method may be illustrated by the treatment of the Socony-Vacuum Oil Company's 18-year, sinking-fund debentures, due in 1955. These bonds were issued in 1937, carried an interest rate of 4½ per cent, and were callable prior to March 1, 1942, at 102. In May, 1939, the company negotiated an agreement with the bondholders whereby the interest rate was reduced to 2⅞ per cent for the balance of the life of the issue. Presumably, the bonds would have been called and refunded had the holders refused to accept the reduction. The fact that the entire issue was held by five insurance companies was an important factor in making the arrangement possible. By having to deal with a small number of investors, the corporation was able to proceed by negotiation instead of calling the issue formally.

The extent to which corporations call bonds for redemption prior to maturity dates is shown in Table 9, which gives the data on the amount of bonds called in alternate years prior to 1940 and annually since that year.

In many respects, Table 9 provides a clue to the motivating influences which underlie corporate financing. Particularly reflected are the effects of general business conditions and the market rate of interest. Always seeking to improve their financial position, corporations take advantage of promising opportunities to reduce the cost of their capital. This was clearly apparent in the late thirties and again just before and after the close of World War II. Because of the lower level of interest rates, corporations were enabled to effect considerable savings by issuing new bonds on much more favorable terms. Another type of adjustment was possible in the late twenties, and again during the fifties, when bonds were replaced with stocks, thereby enlarging the residual equity base as well as providing relief from the burden of a fixed interest cost. Interwoven with these financial actions are the prospects for business conditions which may be the cause of replacing outstanding bonds with new and larger issues to provide additional funds for expansion.

OTHER MEANS OF RETIREMENT

Retirement of a bond issue may also occur under other special circumstances. This is particularly true in the case of convertible bonds, which are automatically liquidated by the exercise of the conversion privilege. This is well illustrated by the convertible income debenture 4's, Series B, due in 1960, of the Capital Airlines, Inc., which were called for redemption in March, 1951; of the $2,728,500 called, all were converted except $19,000, which were paid in cash. Similar action was taken by the same company in November, 1955, when it issued a call for redemption

of all its outstanding convertible 3½ per cent income debentures, due in 1960, in the amount of $491,000. The fact that the bonds could be converted at the time into stock having a market value of $1,210 as compared with the redemption price of $1,000 would undoubtedly prompt the holders to exchange the bonds for stock rather than present them for redemption.

While the nature of convertible bonds will be studied in more detail in Chapter 10, it may be observed here that the conversion privilege serves as a continuing inducement for the liquidation of the bonds under attractive terms of conversion and favorable stock market conditions. Especially is this true where the bonds are issued by well-known companies. For example, the American Telephone and Telegraph Company has floated twelve convertible bond issues ranging from $50,000,000 in 1918 to $718,313,000 in 1958. Up to this time, all such bonds have been converted into stock except $26,280,000 of the latest issue.

Another condition which also effects the retirement of funded debt, unfortunate though it may be, is the failure of a company. In the ensuing reorganization, junior bondholders are often forced to accept preferred or common stock in exchange for at least a part of their holdings. From a market point of view, the results constitute effective retirement of debt just as much as the meeting of a maturity in cash.

SHOULD BONDS BE RETIRED OR REFUNDED?

It is common to think that all corporate debt should be retired eventually, but the accomplishment of such a task is by no means simple. Specific liabilities may be liquidated only to be replaced by new obligations; hence, no change in the total debt occurs. Corporations borrow money for a variety of reasons, which run the gamut from expediency to predetermined basic policy. It is necessary to look to these underlying factors and especially to the use of the funds and the existence of a continuing need to determine whether permanent retirement of debt is desirable.

In the industrial field, it is reasonable to expect the creation of a sinking fund to retire at least a portion of the debt. The character of the assets and the pronounced variations in income call for offsetting provisions in the liquidation of debt, especially if the interests of investors are given first concern. The railroads and the public utilities represent relatively permanent enterprises and offer more justification for long-term issues without retirement provisions. Even in these fields the hazards of debt obligation have become apparent since the so-called "new era" of the twenties.

Primary emphasis has been placed upon the soundness of the corporation as a whole in showing the need for a conservative program for debt retirement. Actually, some conflict of interest may exist between the bondholders and the stockholders. The former would naturally favor the

attachment of conditions that would add to the safety of their investment; the latter may prefer continuous borrowing because of the opportunity to realize greater profits. Management must necessarily recognize the rights of both sides and seek to work out a compromise that can be justified in the light of business soundness. Clearly, any new enterprise should provide for regularized reduction of debt. For established companies, experience will do much to determine the extent to which borrowing should be used as a means of raising capital. Perpetual debt is undesirable in any event. There is a healthy, stimulating effect on management when it must periodically meet maturing obligations. This condition is lacking under perpetual bond issues.

IN PERSPECTIVE

Viewed in the aggregate, bonds provide a significant source of funds for the corporation and offer a variety of outlets for investors. The issuance of bonds requires a continuing appraisal of these two underlying influences. Corporate officials naturally seek to obtain the maximum flexibility of bond terms and conditions, both to minimize the burden on the corporation and to be in a position to take advantage of opportunities for more favorable financing. On the other hand, investors as a group have changing moods that run the gamut from emphasis upon yield to insistence upon maximum security. All these pressures take expression in the money market which, like the weather, may have short- and long-term movements. Occasionally, stocks come into their own as in the late twenties and again in recent years; more frequently, bonds are the preferred medium of investment, and corporations are compelled to respond accordingly. Indeed, it may be said that high-grade bonds may be sold under almost any conditions, assuming that the rate of return and other accompanying terms and features are geared to meet the necessities of the moment. A wide variety of bonds is available for use, as will be seen in our discussion in the next three chapters.

QUESTIONS AND PROBLEMS

1. Distinguish between the nature of bonds and stock from (*a*) the management point of view and (*b*) the investment point of view.
2. Discuss the difficulties in developing standardized terminology for bonds and securities in general, and (*a*) consider the influence of legal factors and (*b*) evaluate the influence of titles on the sale of securities.
3. "Since bonds are notes, it makes little difference what such securities are titled." Discuss.
4. Discuss the difficulties of assuring the complete independence of trustees.
5. "Many forms of conduct, permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place." (*Meinhard* v. *Salmon,* 164 N.E. 545.) Discuss.

6. Discuss the problems that may arise as a result of interlocking interests and relationships between trust companies and the corporations for which they handle securities. (See Securities and Exchange Commission, *Study on Trustees under Indentures.*)
7. On August 26, 1960, the New York Central and Hudson River Railroad Company's general mortgage coupon 3½'s, 1977, sold at 61½, and the registered bonds of the same issue at 58. Discuss the reasons for the difference in price.
8. Discuss the reasons for having common stock on a registered basis while having the vast majority of bonds on a bearer basis.
9. What are the advantages of a sinking fund to the investor? What are its merits from the corporation's point of view?
10. Give an example of a bond with a sinking fund provision for a company in each of the three major fields of enterprise. In each instance, analyze the conditions and terms covering the sinking fund.
11. Explain the difference in the call price for redemption for sinking fund purposes as compared with refunding.
12. Compare the merits of the sinking fund plan with serial maturities, setting forth both advantages and disadvantages.
13. How may the lack of the callability provision retard the most efficient use of a sinking fund?
14. Show how the call feature makes it possible for management to redeem convertible bonds with little risk of cash outlay when conversion terms and stock market conditions are favorable.
15. What are the arguments for and against the use of perpetual bonds, from the point of view of both the issuing company and the investor?
16. "Since individual investors do not have the same expert knowledge of finance and money-market conditions as corporate officials, they are necessarily at a disadvantage in bargaining for the placement of their funds." Discuss.
17. In 1959 the American Telephone and Telegraph Company issued 5⅜ per cent debentures, due in 1986, in the amount of $250,000,000. In June, 1961, the company called these bonds for redemption and sold a new offering, due in 1998, for a comparable amount bearing a rate of 4¾ per cent. Discuss the reasons for such redemption and the position of the investors affected.

REFERENCES

Bogen, J. I. (ed.). "Bond Financing and Borrowing," *Financial Handbook*, pp. 468–86, 515–24. New York: The Ronald Press Co., 1957.

Burtchett, Floyd F. and Hicks, Clifford M. *Corporation Finance*, chap. vii. Lincoln, Nebr.: Johnsen Publishing Co., 1959.

Fletcher, William Meade. *Cyclopedia of the Law of Private Corporations*, Vol. 6A, chap. 30. Rev. and permanent ed. Chicago: Callaghan & Co., 1950.

Guthmann, Harry G. and Dougall, Herbert E. *Corporate Financial Policy*, chap. vii. Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1955.

Prather, Charles L. *Financing Business Firms*, chaps. 20, 23. Rev. ed. Homewood, Illinois: Richard D. Irwin, Inc., 1961.

SCOTT, A. W. "The Trustee's Duty of Loyalty," *Harvard Law Review,* Vol. XLIX, No. 4 (February, 1936), pp. 521–65.

Statistics of American Listed Corporations (A Work Projects Administration Study Sponsored by the Securities and Exchange Commission, 1940), Part I, pp. 16–21, and supporting tables.

WINN, WILLIS J. and HESS, ARLEIGH, JR. "The Value of the Call Privilege," *The Journal of Finance,* Vol. XIV, No. 2 (May, 1959), pp. 182–95.

Chapter 8 ►

SECURED BONDS—REAL PROPERTY

THE PROVISION of specific security for indebtedness reflects in many ways the "give and take" which is often a feature of management motivation. On the one hand, failure to discharge the obligations of the debt leads to loss of title to the assets involved; on the other hand, assumption of this risk may be necessary to obtain the desired funds, or it may be attractive in terms of the relative cost of money. With these thoughts in the background, we may now explore the nature of secured bonds and observe the factors which have a bearing on management or investment interests.

While all bonds are supported by the general credit of the issuing corporation, secured bonds have the added security of a preferred claim to a portion or all of the assets. The significance of the latter feature may be made clear by stating the rights of creditors in the event of failure. In such a contingency, the secured bonds would have the following means of protection:

1. Prior claim to the property specified as security for the bonds.
2. In the event this property failed to be of sufficient value to cover the face value of the bonds plus accrued interest, the bondholders would share equally with the unsecured creditors for the balance of their claim.

From the viewpoint of the investor, the conclusion should not be drawn that all secured bonds are per se preferable to unsecured bonds. Likewise, from the corporation's point of view, it does not necessarily follow that secured bonds will sell to better advantage than unsecured; that is, that funds may be obtained at lower rates of interest with secured bonds than with unsecured bonds. The benefits of specific security naturally depend upon, first, the value of the property advanced as security and, second, the financial position of the corporation issuing the bonds.

As to the first point, it is essential that the property subject to the lien possess both immediate and prospective value. Property having little or no value to the corporation in connection with its continuous and successful operation affords little protection to security holders. An example

would be a bond secured by a little-used or soon-to-be-abandoned branch of a railroad. On the other hand, property that is vital to the continued business life of the corporation would offer a considerable degree of protection to investors. Of course, the most valuable type of security would be property that would retain its value regardless of the continued existence of the corporation. Such would be any property readily salable to another business. Moreover, the normal value of the property should be sufficiently in excess of the liabilities affected to provide a cushion against possible decline in value or losses in the process of liquidation. In fact, an excess amount of security is one of the requisites of a high-grade secured bond.

Investors sometimes have the feeling that the financial position of a corporation may be ignored wherever specific protection is provided. On the contrary, property values are affected vitally by the condition of the operating corporation. Actually, the success or failure of the corporation is a test of the desirability of the property. Rarely can specific security be liquidated under forced sale at a price sufficiently high to bring full recovery for the security holders. However, in the event of reorganization, the first-mortgage bonds may retain their original position without reduction.

THE MORTGAGE

There next arises the question as to the means by which specific property security may be claimed for the protection of a secured bond. This is the purpose of the mortgage, which has been defined by one well-known authority as a "conveyance of an estate by way of pledge for the security of a debt, and to become void upon payment of it."[1] The following is a copy of a mortgage in short form:

MORTGAGE TO SECURE A DEBT, WITH POWER OF SALE—
SHORT FORM

This Indenture, made the .... day of ...., in the year ...., between .... (name, residence, and occupation of mortgagor) party of the first part, and .... (name, residence, and occupation of mortgagee) party of the second part, Witnesseth: That the said party of the first part, in consideration of the sum of (the amount of the debt) to him duly paid before the delivery hereof, has bargained and sold, and by these presents does grant and convey to the said party of the second part, and his heirs and assigns forever, all (here describe the premises minutely and accurately) with the appurtenances, and all the estate, right, and title, and interest of the said party of the first part therein.

This grant is intended as a security for the payment of (here describe the debt) which payments, if duly made, will render this conveyance void. And if default shall be made in the payment of the principal or interest above men-

[1] Chancellor Kent, *Kent's Commentaries* (11th ed.; Boston: Little, Brown & Co., 1867), p. 147.

tioned, then the said party of the second part, or his executors, administrators, or assigns, are hereby authorised to sell the premises above granted, or so much thereof as will be necessary to satisfy the amount then due with the costs and expenses allowed by law.

In witness whereof, the said party of the first part has hereunto set his hand and seal the day and year first above written.

(*Signature*) (Seal)

Sealed and delivered in the presence of

STATE OF
COUNTY OF } ss.

On the .... day of ...., in the year one thousand nine hundred and ...., before me personally came (name of mortgagor) who is known to me to be the individual described in, and who executed the foregoing instrument, and acknowledged that he executed the same, as his free act and deed.[2]

It will be noted that there are two parties to the contract, the mortgagor and the mortgagee. The mortgagor is the borrower, whose property, as security for the loan, is deeded to the lender, known as the mortgagee. However, it is expressly provided that upon payment of the obligation the conveyance of title is nullified. This privilege is known legally as the "defeasance clause."

The illustrated mortgage form is much simpler than those used in most actual transactions and is intended only as a means of visualizing the basic elements. Mortgages become more complex according to the scope of their use and also vary in their legal make-up from state to state. The three main forms are (1) mortgage with defeasance clause which requires the aid of a court to foreclose upon default; (2) mortgage with defeasance clause which vests the power in the mortgagee to sell the property upon default; and (3) deed of trust, which in the habendum clause sets out the conditions upon which the property was conveyed and gives to the trustee named in the deed power to sell the property upon default. All three types, while using different names to describe the parties, have the following basic features in one form or another:

1. The commencement, including the names and residences of the mortgagor and mortgagee, and the date.
2. Statement of the indebtedness secured.
3. Grant and description of the real property transferred.
4. The habendum clause, formerly used to define the estate granted. Its offices are now usually performed by other parts of the mortgage.
5. Defeasance clause, providing that the transfer shall be void upon payment of the indebtedness.
6. Covenants of title and warranty.
7. Covenants to pay taxes and to insure.
8. Provision for accelerating maturity of debt on failure to pay installments or interest when due or in case of breach of other covenants.
9. Provisions relating to foreclosure and sale, including in some states a power to sell without resorting to the courts.

---

[2] *Everybody's Legal Adviser* (New York: published by Doubleday, Page & Co. for Funk & Wagnalls Co., 1922), Vol. VI, Appendix.

10. Release of dower and homestead rights.
11. Conclusion—signatures of parties, and of witnesses when required.
12. Certificate of acknowledgment before a notary public or other qualified authority.

Large corporate mortgages contain these same basic features but are noted for their length, usually 100 pages or longer. Actually, the mortgage is combined with the other provisions in the indenture discussed in the preceding chapter. As indicated at that point, it is common to designate the instrument as a "mortgage indenture." Under a corporate mortgage, the mortgagee is made up of the individual and the institutional bondholders. Again, as in the case of an ordinary trust indenture, it would be very expensive, if not physically impossible, to provide each of the separate bondholders with a copy of the mortgage indenture or to deal with them individually. As a result, a trustee serves as the agent of the bondholders to protect their legal rights and interests as mortgagee. The mortgage indenture is made a part of the security by a reference clause which appears in the bonds held by the investing public.

TYPES OF MORTGAGES

To see the mortgage structure in perspective, we may classify the various characteristics as follows:

A. According to priority of claims
   1. First, second, etc.
   2. Senior and junior
B. According to the right to issue additional securities
   1. Closed
   2. Open-end
C. According to the scope of the property covered by the mortgage
   1. Specific
   2. Blanket
   3. Blanket with after-acquired clause

Before discussing these various features, it should be noted that the delineations are for convenience of explanation only, since a single mortgage could fall into all three categories. To illustrate, a mortgage could have a first lien, be closed to further issues of securities, and be secured by a specific piece of property. Obviously, other combinations could also be developed.

PRIORITY OF CLAIMS

If there is more than one mortgage on a piece of property, the first one recorded has the prior claim and is known as the "first mortgage." The second one recorded is known as the "second mortgage" and is junior in standing to the first mortgage. The term "junior claim" means

that there are one or more claims having a higher or senior rank in relation to the junior lien. The status of the first and second mortgages is best understood by assuming a case. A piece of property may have two outstanding mortgages against it, as follows: a first mortgage of $50,000 and a second mortgage of $30,000. The first mortgage bears an interest rate of perhaps 5 per cent, and the second mortgage will ordinarily bear a higher rate because of the greater risk; in this case, 7 per cent may be assumed. Default occurs in the payment of the interest on the second mortgage, thereby causing its holders to institute foreclosure proceedings. The court offers the property for sale, and we may assume that it is sold for $60,000. After the payment of court costs involved in the foreclosure, the first mortgage has prior claim to $50,000 plus interest. Any balance which may remain will be paid to the holders of the second mortgage.

Accompanying every mortgage is a note promising to pay the entire amount of the debt. This note may be used as the basis for a suit against the mortgagor to collect out of other assets held by the borrower but not covered by the original mortgage any deficiency due the mortgagee. In other words, any balance due the mortgagee constitutes a claim against the borrower with the same status as the unsecured claims of the general creditors.

Terms of a more general nature are often employed in corporation finance to designate the priority of mortgages. Those having prior claims are known as "senior mortgages," while all subsequent liens are called "junior mortgages." The former may take the form of so-called "underlying mortgages" securing bond issues of relatively small amounts. The lien usually covers only a portion of the property, and its use is particularly applicable to railroads—here it is quite simple to limit the claim to a designated portion of the track. While a single underlying mortgage may not seriously endanger the succeeding claims, there are frequently several underlying mortgages which in total may constitute a serious obstruction to the junior securities.

From the point of view of the corporation, the terms "senior" and "junior" are preferable to the simpler terminology of "first" and "second" mortgages. Obviously, an outright second mortgage will lack sales appeal; and bond issues based on such a mortgage are usually camouflaged in order to sell them at a satisfactory price. Corporations have done this successfully in one of two ways: either by making the security partially a first mortgage, or by using a variety of names such as general, refunding, improvement, extension, or consolidated mortgage. By so doing, emphasis is placed upon the use of the funds; and attention is diverted from the true priority status of the lien. Numerous examples of these devices exist. The following are selected examples of bond issues based in part on a first mortgage:

Southern Railway Company's first consolidated gold 5's, due in 1994, are secured by a first lien on approximately 3,339.35 miles of track, and the pledge

of other railroad bonds, railroad stocks and other securities having a total par value of $23,251,067.

Reading Company's first and refunding 3⅛'s, due in 1995, are secured by a first lien on 2,238.25 miles of track, a second lien on 79.57 miles, a first lien on 761.32 miles of leasehold track, and additional direct liens on terminal and rolling equipment, and are further secured by pledge of various stocks and bonds with a face value of $7,319,500.

Norfolk and Western Railway's divisional first consolidated gold 4's, due in 1996, are secured by a first lien on 1,380.16 miles of line and a second mortgage on 124.96 miles of line.

The following cases are representative of the second method, wherein the company uses a descriptive title to divert attention from the true nature of the lien:

New York Central and Hudson River Railroad Company's refunding and improvement mortgage gold 4½'s, due in 2013, are secured by a first mortgage on 636.60 miles of line, a second mortgage on 169.08 miles, a third mortgage on 14.31 miles, a fourth mortgage on 2,302.95 miles, a fifth mortgage on 431.79 miles, and a sixth mortgage on 171.09 miles. To these must be added other leasehold, equipment and property security.

Illinois Central Railroad's consolidated 4⅜'s—3¾'s, Series A, due in 1979, were originally secured by a first lien on 617 miles of line, a second lien on 1,988 miles, a third lien on 2,510 miles, a fourth lien on 736 miles, and other forms of miscellaneous security; currently, they are secured, along with three other issues, by a direct lien on 5,894.38 miles of owned track and on 20.78 miles of leasehold track.[3]

Lehigh Valley Railroad Company's consolidated 4½'s, due in 1989, are secured by a first lien on 14.4 miles of track and a second lien on 239.44 miles.

AMOUNT OF BONDS WHICH MAY BE ISSUED

A mortgage is of significance in corporation finance not only as an instrument to secure a lien upon property for the protection of the bondholders, but in addition it may have a decided influence upon the type and amount of financing. Since the mortgage is primarily a means of protection to the security holder, it is clear that this protection would not be complete without some stipulation as to the amount of securities which may be issued in the future. More specifically, provision may be made to cover the following two contingencies:

1. The amount of bonds which may be issued on the basis of property owned at the time the mortgage is placed.
2. The right to issue bonds based upon additional property which may be obtained in the future.

Failure to provide for these two important details in the mortgage may prove detrimental to the welfare of the investors, or to the corporation, or both, at a later date. If no statement is made covering the issuance of securities in the future, the corporation will be free to act according to

[3] Interest on these bonds was payable at the rate of 4⅜ per cent to 1955 and thereafter at 3¾ per cent.

its own discretion. On the other hand, it is possible to curb unduly the future financial program of the company. These principles may be seen to better advantage by a study of the characteristics of closed and open-end mortgages.

CLOSED MORTGAGES

Under a closed mortgage, no bonds of similar rank may be sold other than those of the initial issue. This restriction affords excellent protection to the investors but may place undesirably rigid limitations on the corporation's financing. The effect is especially far-reaching where the mortgage also contains an after-acquired clause extending the lien to cover all additions to the company's property in the future as well as the property already owned. While methods exist for avoiding the after-acquired clause, they are not entirely satisfactory. After-acquired clauses destroy desirable flexibility in financing, which may be of benefit to both the corporation and the investor. Management may be unneccssarily restrained in undertaking profitable expansion. In turn, the investor may suffer where restrictions prevent improvement of the earnings position.

A simple example of the use of the after-acquired clause is found in a mortgage executed by a sawmill company which described the existing property security and included "all plants, mills, factories, buildings . . . with their . . . equipment and accessories of the company now or at any time thereafter located on or appurtenant to or in connection with any real property hereinabove described." Thereafter, a planing mill and lumberyard were placed on land not specified in the original mortgage. Even though the company had never previously operated a planing mill, the court held in connection with resulting legal action that "the inclusion of plants later established to meet business changes or improvements was clearly contemplated."[4]

The closed feature is a fairly common characteristic of the divisional or underlying mortgages of railroads which were mentioned earlier. Examples are the first gold 4's, due in 1987, of the Kentucky Central Railway, with a first lien on 211.83 miles of line; and the first gold 3's, due in 1989, of the Sturgis, Goshen and St. Louis Railway Company, with a first lien on 29.4 miles of road. Both issues are noncallable and have no provision for a sinking fund, and both companies are subsidiaries of larger railway systems. In the public-utility field, the first-mortgage 2¾'s, due in 1975, of the New York Power and Light Corporation may be noted. These bonds were issued in 1945 and constitute a "first mortgage lien on all properties and franchises" of the company other than the usual exceptions of current and miscellaneous assets. No additional bonds may be issued except for purposes of refunding.

[4] *Chase National Bank* v. *Richmond Cedar Works,* 5 U.S. Law Week 710.

OPEN-END MORTGAGES

The term "open-end" is used to cover a variety of conditions which permit the issuance of additional securities. The extent to which bonds may be issued with the same mortgage as security range from a fixed and specified total amount irrespective of property additions to amounts that are governed by prescribed standards which seek to prevent any increase in the risk. The mortgages are sometimes designated as "limited open-end" and "unlimited open-end," respectively; also, the term "open-end" has been used to denote the former and "open" to describe the latter. However, in actual practice, the term "open-end" is generally used to embrace both sets of conditions, irrespective of the refinements.

To illustrate the type of control obtained by fixing a maximum amount of bonds which may be issued irrespective of property additions or other changes, reference may be made to the first mortgage bonds of the Texas Gas Transmission Corporation. The total authorization for all such bonds is $150,000,000, and the four following series are currently outstanding: 3⅝'s, due in 1968, in the amount of $31,500,000; 4's, due in 1971, of $25,120,000; 4⅞'s, due in 1976, of $23,600,000; and the 5⅝'s, due in 1979, of $30,000,000. All series of these bonds are secured equally and ratably by a first mortgage "on all land, buildings, gas pipe lines, equipment, etc., owned or after acquired." Among the restrictions prescribed by the indenture are the provisions that the company may pay cash dividends on the common stock: (1) if its net income after March 31, 1948, is more than such dividends plus $7,000,000, or (2) if the net income is not less than the dividends provided the funded debt is less than 70 per cent of the total capitalization (bonds, preferred stock, common stock and surplus).

Another example of the limited open-end mortgage is found in the financing of the South Carolina Electric and Gas Company. Initially, it sold $8,000,000 of first-mortgage and refunding 3 per cent bonds, with authority to float additional issues under the same mortgage up to an aggregate of $50,000,000. Thereafter, it issued a 3⅝ series, due in 1973, in the amount of $19,000,000; and a 3⅜ series, due in 1978, for $3,200,000. Then, in 1950, the company called these last two issues for redemption, replacing them with a single issue of first and refunding 3 per cent series, due in 1980, in the amount of $22,200,000. Under the indenture covering this issue, the total authorization for all series of bonds was increased to $100,000,000. Operating under this authority, the company later issued the following bonds: Series A 3's, due in 1980, for $4,000,000; 3¾'s, due in 1981, for $6,000,000; 4⅛'s, due in 1983, for $4,000,000; 3½'s, due in 1985, for $5,000,000; 5½'s, due in 1987, for $10,000,000; and the 4⅞'s, due in 1988, for $10,000,000. It should also be noted that two issues of the South Carolina Power Company, which were assumed by the subject

company in 1950, are secured by the same mortgage and are included in the total bond authorization.

Although release from the limitations of an open-end mortgage may usually be effected by calling the related bonds for redemption, even greater freedom of action may be obtained by the use of an open mortgage. Under the latter arrangement, new issues may be floated without limit on the basis of meeting prescribed requirements. An illustration is the first and refunding mortgage 4's series A due in 2007, of the New York, New Haven & Hartford Railroad Company, where it is specified that new bonds may be issued under the following conditions: (1) equivalent amounts for the purchase of other obligations of the company having priority of lien; (2) for the purchase of bonds issued under the same covering mortgage; and (3) for "betterments" in amounts equal to 75 per cent of the applicable expenditures.

Such requirements as the foregoing obviously provide the flexibility which is necessary to meet changing financial and operating conditions. Particular attention is called to the limitation on new bonds to finance improvements which may not exceed 75 per cent of their cost; as may be seen in the examples cited below, a ratio of 60 per cent is common for public utilities. Without such restriction, it would be possible to dilute unduly the ratio of the value of the protective lien security to the total outstanding bonds.

The first 2¾'s, due in 1975, of the Texas Power and Light Company may be cited as another example. Sold in 1945, provision is made for issuing additional series based on a supplemental indenture if the prescribed standards are met. Among other things, any new bonds may not exceed 60 per cent of the cost or fair value, whichever is less, of the property acquired; and net earnings must be equal to at least two times the interest charges on all first-mortgage and prior-lien bonds. As would be expected, an exception is made for refunding issues. Since the offering of the original bonds, the company has sold six additional series, the latest being the first 4½'s, due in 1988, that were issued in 1958.

In the Brockton Edison Company first-mortgage and collateral trust 3's, due in 1978, the initial issue was limited to a flat sum of $1,500,000 on the basis of the property existing at that time; but the issuance of new securities is permitted up to 60 per cent of the value of net property additions, including the pledged securities of an affiliated company. The indenture covering the first 3⅛'s, due in 1973, of the Northern Indiana Public Service Company permits additional bonds up to 60 per cent of the "net expenditures" for property additions; and the provision relating to the first 2¾'s, due in 1975, of the Northern States Power Company (Minnesota) authorizes additional issuance up to 60 per cent of the cost or fair value, whichever is the lesser, of the improvements.

The principle underlying the unlimited open-end mortgage is sound and is of value to both the corporation and the investor if hedged with the

proper restrictions, such as requiring adequate coverage of the fixed charges and limiting new issues to a fair percentage of the value of property additions. At the same time, there is need to avoid restrictions that may unduly curb management authority because the resulting immobility can harm the corporation and be detrimental to the best interests of the investor. Realism also suggests that provision be made for amendment of restrictions in order to meet changing conditions.

MORTGAGES CLASSIFIED ACCORDING TO SCOPE OF LIEN

Not only is there a question as to whether or not the mortgage should cover property acquired in the future, but in addition a decision must be made as to what extent the mortgage may cover the property currently owned. Shall the mortgage cover all or only a portion of the property? The answer to this question may be found in an analysis of the following factors and conditions: (1) the existence of other mortgages, (2) the size of the financing to be undertaken, and (3) the field of enterprise.

If other mortgages are outstanding, the new mortgage must necessarily give consideration to the existing liens. As a consequence, the new mortgage may be a first lien on certain pieces of property combined with a junior lien on other parts; or numerous other potential combinations may be worked out, as shown elsewhere in this chapter. The amount of the new financing is also a factor. A first lien on a large and valuable piece of property is not warranted for the sake of minor financing; and, oppositely, it is impossible to base a large financing program upon inadequate property protection.

Finally, the field of enterprise exercises a broad influence. The property of an industrial plant is much more concentrated in character than that of most utility or railway companies. Railroad property, particularly, is diversified and extended over a wide area; and it is much easier to utilize the separate divisions as a basis for mortgage bonds. Security issues of this type are usually designated as "divisional mortgage bonds." They offer an adequate security to the investor, provided, of course, that the portion of property is essential for the operations of the company. In an industrial concern, the division of property is not as feasible and has less appeal to investors.

SPECIFIC VERSUS BLANKET MORTGAGES

Allowing for the diverse circumstances which are found in business, mortgages may be conveniently classified according to the scope of their lien into "specific" and "blanket." A specific mortgage grants a lien on a particular piece of property only, while a blanket mortgage covers all the property of the corporation. The following cases are representative of these two types:

Specific. The Abilene and Southern Railway, a subsidiary of the Texas and Pacific Railway Company, has 6 per cent gold bonds outstanding, secured by first liens on 54.65 miles of main track and 7.29 miles of siding. This is one of many instances of divisional railroad mortgages, which usually have a first and specific lien; in the subject case, the bonds are wholly owned by the parent company and have been kept alive beyond their maturity date.

Blanket. The Public Service Company of Colorado's first 2⅞'s, due in 1977, are "secured equally and ratably with all bonds issued hereunder by a direct first lien . . . upon all property, rights, privileges and franchises now owned or hereafter acquired. . . ." except for the customary exclusion of current assets and other miscellaneous items.

An example of an industrial bond which combines the blanket feature with an after-acquired clause is found in the bonds of Cudahy Packing Company. Its first sinking fund 2⅝'s, due in 1967, are secured by a "first mortgage lien on land, buildings and fixtures of the company now owned or hereafter acquired . . ." and by the pledge of capital stock of affiliated companies.

MEANS OF AVOIDING THE AFTER-ACQUIRED CLAUSE

Whenever the after-acquired clause is present in a closed mortgage, management is compelled to effect desired financing either on a junior-lien basis or by evasion of the restrictions. The latter may be accomplished by any one of several means, such as the following:

Calling the Bonds. Where the right of calling the existing bonds is present, the path for new financing is easily cleared simply by exercising this privilege. The new issue would then be for an amount sufficiently large to cover the old bonds and the expenditures for expansion.

Use of a Purchase-Money Mortgage. For purposes of corporation finance, this method is limited mainly to the financing of railroad equipment. The title to the new property is reserved in the vendor either by conditional sale or by a lease arrangement and consequently escapes the force and effect of the after-acquired clause.

Merger or Creation of a Subsidiary Company. In those instances when the consolidation of different companies is feasible and desirable, relief may be obtained because the parent or merging company would not be bound by the restrictions on bond issues of the company taken over. Similarly, a new subsidiary company may be organized and the bonds sold under its name. However, the subsidiary would obviously not be well known; and the marketability of the new issue could be adversely affected.

By Means of a Lease. Corporations may also obtain the use of property by means of a lease arrangement, comparable to the ordinary rental of a house. The title would necessarily remain in the lessor, and any after-

acquired clause relating to the bonds of the lessee corporation would naturally be ineffective. Traditionally, this practice has long been used by railroads to acquire additional rights-of-way; but, more recently, the same principle has been used by industrial companies, although mainly for reasons other than avoidance of the after-acquired clause.

These simple means of evasion suggest the difficulties of freezing the investment contract and make clear that the integrity of management may be even more important in maintaining the priority of the security of existing bondholders. Indeed, as stated previously, investors gain little by putting management in a financial strait jacket; rather, reasonable provisions should be provided to meet the contingencies of changing business conditions.

TYPES OF BONDS SECURED BY REAL PROPERTY

So far in this chapter, the discussion has been concerned mainly with the mortgage; for financial purposes, this document is incidental to the bond. Most of the powers and rights granted to a bond issue are incorporated in the mortgage and the accompanying indenture, but the bond is the means of direct contact between the corporation and the investing public. For this reason, it is essential to have clearly in mind the various types of bonds used. If bonds and their terminology were standardized, such a task would be simple; unfortunately, under existing practice, it is especially difficult. It is one thing to state what the name of a bond should indicate, but the facts may not be in accordance with the title. The investor should always investigate the security and other aspects of a bond issue and not place too much reliance upon the name.

To appreciate the wide range of bond titles and the mixture of underlying security, a brief recital of various representative issues may be set forth:

First-Mortgage Bonds. As the name indicates, the security for this type of bond should consist of a mortgage having a first claim on designated assets. An illustration is the Kaiser Steel Corporation first-mortgage 3¾ per cent bonds, due in 1970. These bonds are secured by a first lien on specific properties (detailed on 70 pages in the mortgage indenture) and also "all other real property and interests in real property, whether now owned or hereafter acquired by the Company . . . except as . . . expressly excepted."

General Mortgage Bonds. General mortgage bonds have as security a broad mortgage covering a large portion of the company's property. The lien position may be mixed with a first claim on part of the security and a secondary one on the balance; or the mortgage may be wholly secondary. For example, the Northern Pacific Railway Company general lien 3's, due in 2047, are secured by a lien on 4,914.91 miles of line and other miscellaneous properties, subject to the prior-lien mortgage

railway and land grant 4's, due in 1997, but are ahead of the refunding and improvement 4½'s, due in 2047. When bonds with priority are liquidated, the general mortgage bonds assume a senior-lien position. The Brooklyn Union Gas Company general mortgage 2⅞'s, due in 1976, now have a first lien on substantially all the fixed properties and franchises of the company.

Refunding and General Mortgage Bonds. This type of bond is issued mainly for refunding purposes with a general mortgage as security. The latter may consist of various lien positions and other miscellaneous forms of protection, as illustrated by the Texas and Pacific Railway Company's general and refunding 3⅞'s, due in 1985. Outstanding in the amount of $25,166,000, these bonds are secured by a second or general mortgage, subject to the prior lien of the first gold 5's, due in 2000, in the amount of $18,961,000, and are further secured by a general claim on the equipment subject to outstanding equipment trust obligations. Again, it is possible for such bonds to be secured almost entirely by a first lien, as is the case in the Detroit Edison Company general and refunding mortgage 3's, due in 1970; 2¾'s, due in 1982; 2¾'s, due in 1985; 3⅜'s, due in 1976; 2⅞'s, due in 1984; and 3¼'s, due in 1980.

Refunding and Improvement Bonds. Bonds of this class are usually issued for the dual purpose of refunding a maturing or called issue and at the same time providing funds for expansion or improvement of the property. Illustrative are the refunding and improvement 4's, Series C, due in 2019, and the 2⅞'s, Series D, due in 1985, bonds of the Terminal Railroad Association of St. Louis. The 4's were used to buy stock of the St. Louis Bridge Company and the Tunnel Railroad of St. Louis, and the 2⅞'s to refund previously outstanding issues. Both series are secured by a first lien on the passenger station, tracks, and equipment; by a collateral lien on two bridges and a tunnel; and by pledge of securities.

First and Refunding Bonds. This type of bond is generally secured by a first mortgage, but a junior-lien position may exist in part. As the name suggests, the main purpose of such bonds is to refund maturing obligations; but it is common to raise additional funds at the same time in order to finance improvements and extensions. For illustration, reference may be made to the first and refunding mortgage bonds of the Consolidated Edison Company of New York, of which there are eighteen series with maturities ranging from 1972 to 1990 and with interest rates ranging from 2⅜ per cent to 5¼ per cent. The underlying security consists of a first lien on substantially all properties and franchises but holds a secondary position to two small issues on parts of the plant. The latter—the Edison Electric Illuminating Company of New York's first consolidated gold 5's, 1995, and the King's County Electric Light & Power Company's purchase-money gold 6's, 1997—were issued in 1895 and 1898, respectively, and are noncallable; as a result, these two issues continue to hold a first-lien position on the property covered by the mortgage.

Consolidated Mortgage Bonds. These bonds are issued upon a mortgage or a number of mortgages with a claim against several properties. For example, the consolidated mortgage 2¾'s, Series I and J, and 3's, Series K, of the Bethlehem Steel Corporation are secured by a first lien on practically all properties except about 55 per cent of the acreage of the Lehigh Division of the Bethlehem plant, where they hold a second lien which is junior to the Bethlehem Steel Company's noncallable purchase-money 6's, due in 1998, which were issued in 1901. The bonds are also secured by a first lien on various pledged securities.

First Consolidated Bonds. Strictly interpreted, a first consolidated bond does not imply that a first mortgage exists; but it, along with the expression "first and consolidated," is likely to be covered wholly or in part by a first lien. For example, the first consolidated mortgage 2's, 3⅛'s, and 3¼'s of the Erie Railroad are secured partially by a first lien and partially by a second lien.

SECURED BONDS AND FIELDS OF ENTERPRISE

Varieties of bonds are more numerous in the railroad field than in any other because of the greater development and longer history of the railroads and because of the fact that the railroad plant is more easily divided for purposes of mortgage security. Unfortunately, many railroads have also issued mortgage bonds for reasons of necessity rather than choice. During the early life of the railroads, it was expedient to issue a well-protected security to attract foreign capital; in still later years, the use of stock as a means of financing was retarded by numerous failures and the resulting comparatively weak credit standing. During World War II and the early postwar period, increased traffic did much to vitalize earnings and to strengthen the financial position. But it would seem that the railroad problem is perennial, since recent times have once again revealed heavy pressures upon railroad operations. Needless to say, there is sympathetic effect upon the covering financing.

In the industrial field, the mortgage bond is not nearly so much in vogue. This may be partly the result of tradition; but, in most instances, the plant investment is not as large proportionately as it is for rails and public utilities. As a consequence, it is common to issue unsecured bonds which provide that they will assume prior or equal security in the event that any mortgage bonds are issued in the future. Where the mortgage bond is used in the industrial field, a large fixed investment is usually present, such as is found in the iron and steel industry.

The public-utility field offers an excellent basis for the issuance of mortgage bonds. This applicability is restricted more particularly to operating companies inasmuch as pure holding companies lack the direct ownership of real property which is necessary for the establishment of a lien. Variation is found also according to the major divisions of the indus-

try. Electric light and power companies (operating) and water-utility companies are inclined to use mortgage bonds more freely than the companies producing gas or furnishing telephone service. This is a reflection, in part, of the tradition prevailing within each industry and, in part, of the relative degree of permanence in the operating plant.

One large utility system formerly took pride in the fact that it was able to finance its operations without utilizing a single mortgage.[5] The capital requirements were met through the issuance of unsecured obligations of the holding company, i.e., notes or debenture bonds. This utility organization, as well as others, even went so far as to provide its own selling organization. The chief argument advanced for the use of unsecured financing on such an extensive scale is the claim that the security covers the property of the entire system. A further advantage, more especially from the standpoint of the corporation, is that the mortgage bond issues may be reserved to provide funds when market conditions are more stringent. In the words of one financier:

> The plan contemplates that under normal market conditions the capital required for the extension of the company's system and for the acquisition of additional properties to broaden its scope and business will be provided through the sale of debentures of the parent company, and should funds be required under adverse market conditions, as, for instance, in a period of panic, they can be made available through the sale of the mortgage secured obligations of any of the numerous constituent operating companies.[6]

VALUE OF SPECIFIC SECURITY TO THE INVESTOR

As indicated at the beginning of this chapter, specific security does not automatically provide the investor with a cloak of armor against failure. Attention must also be given to the income position of a company. A sound and stable income supply provides continued economic buoyancy and solvency, but the security afforded by lien is of use only ultimately or under emergency conditions. The value of a senior lien in time of failure and reorganization has been demonstrated on more than one occasion. The secured holder is in a position to demand better treatment than the unsecured creditor, and cases are known in which the security holders have actually benefited by a reorganization.

BOND MATURITIES

Probably no tight rule may be established with respect to the fixing of the maturities of bonds. Those with prime mortgage security may pos-

---

[5] The Associated Gas and Electric Company. See "Financing without a Mortgage," as reprinted from the *Electrical World,* September 8, 1928. This company later failed and was reorganized.

[6] Quotation of Mr. Frederick S. Burroughs, a vice-president of Harris, Forbes and Company, as reported in a reprint from the *Electrical World,* September 8, 1928.

sibly lend themselves to longer life than unsecured issues, but much more important are money-market conditions and the established financial record of the issuing corporation. For example, the well-known Commonwealth Edison Company was able to sell its unsecured 2¾ debentures in 1950 with a maturity date of 1999, whereas the less recognized Upper Michigan Power and Light Company sold its 3½ per cent first-mortgage bonds with a maturity date of 1964. Indeed, there is little semblance of maturity pattern; and there is reflected mainly the opportunistic character of corporate financing. Maturities may be short because of the high rate of interest or because of anticipated temporary need of funds; conversely, they may be lengthened to take advantage of favorable financial terms, particularly when relatively permanent capital is desired. However, from the point of view of the investor, it may be said that ordinarily the security of a prime mortgage becomes all the more important as the maturity is lengthened. The general credit position of a corporation may not be forecast for such long periods; and a first mortgage, at least, assures him of bargaining rights which may prove valuable.

QUESTIONS AND PROBLEMS

1. "Not even the best mortgage security can take the place of a sound credit or financial position." Discuss.
2. Aside from necessity or expediency, why would a corporation subject its property to a primary lien as a basis for raising capital?
3. Discuss the value of specific security to the investor.
4. "The complicated character of the corporate mortgage makes it essential that an expert in the form of a competent and independent trustee be appointed to protect fully the right of the investors." Explain and discuss.
5. From the point of view of the corporation, discuss the weaknesses of a closed bond secured by a mortgage with an after-acquired clause.
6. List the bonds of any railroad of your selection according to their priority of claim, and note their respective prices or yields.
7. Discuss the advantages of an open-end mortgage (*a*) from the point of view of the corporation, (*b*) from the point of view of the investor.
8. In early 1951, the Montana-Dakota Utilities Company sold $3,000,000 of first-mortgage 3⅝ per cent series bonds, due in 1976, and $2,000,000 of first-mortgage 3½ per cent serial bonds. Refer to *Moody's Public Utility Manual* for other terms and conditions, and discuss the reasons for these issues.
9. "The dynamic character of business necessarily makes it impossible for a bond title to represent the true character of security over an extended period of time." Explain and discuss.
10. What is the nature of underlying mortgages? Why would a corporation usually desire a call provision on issues secured by mortgages of this type?
11. In October, 1950, the Kaiser Steel Corporation placed privately $60,000,000 of first-mortgage bonds, due in 1970, and offered publicly $40,000,000 of preferred and common stock. Consider this plan of financing from a broad policy point of view.

12. Railroads and public utilities use mortgage bonds more extensively than industrial companies. Discuss and evaluate the following factors of influence: (*a*) Relative amount of fixed plant. (*b*) Relative stability of income. (*c*) Money-market traditions.
13. Evaluate the factors that may prompt the use of mortgage bonds by industrial companies.
14. In 1955, the Uranium Reduction Company placed privately $6,200,000 first-mortgage sinking fund bonds, due in 1962: (*a*) What reasons favor the short maturity for this first-mortgage bond? (*b*) Discuss the reasons for a sinking fund.
15. See *Moody's Public Utility Manual,* and determine the nature of the security of the first-mortgage pipeline sinking fund bonds of the Southern Natural Gas Company. Also discuss the following: (*a*) The limitations covering the issuance of additional bonds. (*b*) The variance in the interest rates of the different series.

REFERENCES

BOGEN, J. I. (ed.). "Bond Financing and Borrowing," *Financial Handbook,* pp. 486–94. New York: The Ronald Press Co., 1957.

BRADLEY, JOSEPH F. *Fundamentals of Corporation Finance,* chaps. xvi, xvii. New York: Rinehart & Co., Inc., 1959.

DONALDSON, ELVIN F. *Corporate Finance,* chap. ix. New York: The Ronald Press Co., 1957.

FLETCHER, WILLIAM MEADE. *Cyclopedia of the Law of Private Corporations,* Vol. 6A, chap. 30. Rev. and permanent ed. Chicago: Callaghan & Co., 1950.

GERSTENBERG, CHARLES W. *Financial Organization and Management of Business,* chap. vii. Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1959.

PRATHER, CHARLES L. *Financing Business Firms,* chap. 21. Rev. ed. Homewood, Illinois: Richard D. Irwin, Inc., 1961.

Chapter 9 ►

SECURED BONDS— OTHER PROPERTY SECURITY

THE TYPE or form of security that is used to secure bonded indebtedness is shaped and determined by a variety of circumstances. Particularly influential are capital-market conditions and the purpose for which the funds are to be used; the former are ever present in the background while the latter creates the more immediate setting. Also, both custom and affinity tend to prompt the form of property to be used as specific security for the accommodating obligations. Quite naturally railroads use equipment to protect the securities issued to raise the funds for its purchase, while stocks and bonds acquired as a result of expansion programs are pledged as backing for collateral trust bonds. These and other forms of miscellaneous security will be discussed at some length in this chapter.

As a basis for our analysis, we may first note the differences between the relative appeal and suitability of real and personal property. Broadly speaking, there is likely general preference by investors for the former as security for a bond issue. Fixed property offers a definite and permanent basis of support, while personal property is so mobile that the specific property offered as security may easily disappear from among the assets of the corporation. Personal property is easily moved, has a temporary life, and is being converted constantly into the goods or services that the corporation sells. On the other hand, in time of failure, the ready movability of personal property may prove to be of advantage because it adds to the property's marketability. How to utilize the benefits accruing from the marketability of personal property and, at the same time, avoid its limitations as a form of security is a problem of financial arrangement which will now be discussed.

EQUIPMENT OBLIGATIONS

To be used as a basis for reasonably long-term credit, personal property must first have sufficient life to make a satisfactory lien possible. In-

ventories, receivables, and other current assets do not meet this qualification and are not adaptable as security for long-time corporate financing. The requirement is filled excellently by rolling stock of railroads. Possessing an average life of more than 20 years, and being indispensable to the railroads' operations, it offers a substantial basis for financing. Railroads have taken advantage of this condition and, as of December 31, 1959, equipment obligations constituted 25 per cent of their total long-term debt.

An equipment obligation is a security issued with rolling stock or other equipment as collateral. It was practically unknown until introduced into railroad financing in the latter part of the nineteenth century as a subterfuge for the evasion of the after-acquired clause. Later, equipment obligations came to be recognized in their own right as an excellent means of obtaining low-cost financing. They may be classified into two main types: indirect and direct.

Indirect Obligations. Indirect obligations may be defined as those for which the railroad or other issuing corporation is not directly liable. The corporation's liability is ultimate and actual, but it is not direct. The absence of direct liability is intended to prevent the creation of possible prior claims against the equipment that is to be purchased. In order to escape the after-acquired clause, title to the property must not pass to the railroad; and, at the same time, the railroad must assume final responsibility. This is accomplished by selling the property to a third party, usually a trust company, which issues certificates of interest in the property instead of direct obligations of the railroad. To make the certificates more readily marketable, they are guaranteed by the railroad buying the equipment.

The indirect method is usually known as the "Philadelphia" or "lease" plan. Three parties participate in the transaction: the vendor of the equipment, the trustee, and the railroad. When negotiations between the equipment manufacturer and the railroad are complete as to the details of the equipment, the manufacturer is instructed to sell the property to a properly designated trustee. In turn, the trustee leases the equipment to the railroad; and, in consideration, the railroad promises to pay an initial deposit plus annual rentals.

With the title vested in the trustee, certificates of interest are issued and sold to the public. As a result, the holder of a certificate becomes a partial owner of the actual property, i.e., cars, locomotives, etc. The proceeds from the sale of the certificates plus the initial deposit made by the railroad equals the purchase price of the equipment; and the funds are used to pay the equipment manufacturer. This permits the latter to drop out of the picture, and only two parties remain: the railroad, and the trustee as the agent for the certificate holders.

The annual rentals are sufficient to pay the interest on the outstanding certificates (known as "equipment trust certificates") and to liquidate

a part of the principal. Amortization of the principal is accomplished by having the certificates mature serially. These features, however, apply also to the direct obligations and may be discussed in common at a later point.

Direct Obligations. Practically the same results are achieved with direct obligations but the arrangements and procedures are different. In this case, the vendor sells the property directly to the railroad (not to the trustee, as in the Philadelphia plan), but on the familiar conditional sale basis. The title does not pass to the railroad but remains with the vendor, the equipment manufacturer.

In the event there is *public* distribution of the securities, there are the usual three parties: the vendor, the vendee, and the trustee. The title is assigned to the trustee in consideration of the purchase price, which, in turn, is raised by the initial deposit of the railroad and the sale of the equipment obligations to the public. These equipment obligations, however, are the direct liability of the railroad; in short, they are equipment *bonds*, and not equipment trust *certificates.* The bonds have serial maturity and are secured by the specific equipment purchased by the railroad, thereby preserving these two basic characteristics of equipment trust certificates. This method is designated as the "New York plan," but has not been widely used over the years.[1]

Where arrangements are made for the *private* financing of the equipment, the basic principles of the New York plan are usually adopted. There is a large volume of financial transactions of this type because of the convenience to the railroad as well as the pressure upon institutional investors to find safe outlets for their funds. Arrangements are made with insurance companies, banks and other institutions, who individually or as a small group take all the securities, and advance the funds over and above the initial deposit made by the railroad. Under these circumstances, there is little need for a trustee because of the concentration of the investment. As indicated on page 110, the trustee is a necessary party when there is widespread distribution of the securities, but financial and investment institutions have the capacity and facilities to function in their own behalf. Title to the equipment passes from the seller of the equipment to the financial medium on the usual assignment basis. The obligations in this instance are commonly known simply as notes which, like other types of equipment securities, have serial maturities.[2]

To be strictly correct, the terms "equipment bond" and "equipment note" should be restricted to direct obligations. However, in actual prac-

[1] A slight variation of the New York plan is found in a few cases using the chattel mortgage. In this arrangement, the equipment is sold to the railroad on the condition that it be deeded to the trustee as security for the equipment bonds.

[2] Also large institutional investors, such as life insurance companies, may buy the equipment and lease it to the railroad. See *Wall Street Journal*, June 1, 1950, p. 4, for details of financing Diesel locomotives which are leased for a term of 15 years, with an option to return the equipment or to renew the lease for an additional period up to 10 years.

tice, the term "equipment trust certificate" is used broadly to cover the whole field of equipment obligations.

PREFERENCE FOR THE "PHILADELPHIA PLAN" IN PRACTICE

Confining our comments to the financing of equipment by the public sale of securities, the point may be repeated that the Philadelphia plan is used almost exclusively. Despite the simplicity and convenience of the New York plan, it is generally avoided for the following reasons:

1. The lease plan is valid in all states; but the conditional sale plan is not legal in Pennsylvania, where the lease method must be used instead.
2. The lease plan was the first to be adopted.
3. Under the lease plan, the sale is made to the trustee and not to the railroad. As a result, no pretense is afforded for claiming that the title resides in the latter.

The fundamental differences which exist between the direct and the indirect methods are in a sense trivial; and were it not for a few legal conventionalities and niceties, the direct plan would most likely be employed almost universally. The convenience afforded by the direct method was recognized by the government in 1920, when it used this basis to settle for equipment turned over to the railways after the period of government operation. Fundamentally, the two plans achieve virtually the same results; and obligations issued under the two plans have the same elements of strength as well as other common characteristics. For this reason, no distinction is made between the two types in the following discussion of the security, income, and miscellaneous features of equipment obligations.

SECURITY FEATURES

The legal key to the strength of equipment securities lies in the fact that the title to the property does not vest in the railroad. To quote the words of an indenture:

> Until payment by the Railway to the vendor . . . and to the holders of the notes hereinafter referred to, of the entire purchase price of said equipment, and of all installments and amounts as hereinafter specified, and until all of the obligations of the Railway hereunder shall have been duly complied with and performed, the title to the equipment aforesaid shall not pass or vest in the Railway, but shall remain in the said Vendor. . . .

The practical application of this provision has been tested in many reorganizations, and equipment obligations have always escaped virtually unscathed. Usually, the holders of the equipment obligations have suffered only the inconvenience connected with a temporary default of the interest and principal payments. Both the legal security inherent in the equipment obligation and the ready marketability of the equipment place securities of this type in a key position in time of reorganization.

In the case of default in the payment of interest or principal, "such default continuing for a period of 60 days . . . the Trust Company shall be entitled to, and at its option, may repossess itself of the said equipment, and of every piece thereof, retaining all payments which up to that time may have been made on account of the said equipment." Because of the indispensability of equipment to railroad operations, it has seldom been necessary to make use of this power.

PROTECTION AGAINST DEPRECIATION

Since the railroad equipment is subject to unusually heavy wear and tear, a material diminution of value must occur. Two features are intended to protect the holders of equipment obligations on this account: (1) the presence of an adequate original equity behind the issue and (2) increasing the relative equity throughout the life of the issue. Examination of a number of equipment trust indentures reveals the fact that the initial deposit, or original equity, varies from 15 per cent to 25 per cent, with 20 per cent being common. This means that at the very beginning the outstanding obligations are equal to only 80 per cent of the value of the security. Throughout the life of the trust certificates, liquidation of principal proceeds at a rate faster than the depreciation of the equipment. Not only do the certificates mature serially, but their maximum maturity is less than the average life of the equipment. A conservative estimate of the life of a railroad car is 20 years, while obligations seldom have maturities in excess of 15 years.

MINOR SECURITY PROVISIONS

The trust indenture provides in numerous ways for the maintenance and protection of the equipment. First, the typical maintenance provision declares: "The company during the continuance of this lease, will maintain and keep all of the Trust Equipment in good order, and repair, at its own proper cost . . . , and will replace, at its own cost, any of the Trust Equipment that may be worn out. . . ." Second, the equipment must be properly insured: "Each box car and each stock car and each refrigerator car shall be insured for not less than 50 per cent of the value thereof under the rules and regulations of the Master Car Builders' Association. . . ." Third, the railroad is usually required to render an annual report depicting the condition of the equipment; and, in addition, the trustee has the right to inspect the property. Fourth, adequate restrictions are incorporated in the agreement to prevent the railroad from selling or transferring the property, e.g.: "The Railway agrees . . . not to part with the possession of any of such equipment . . . [except so far as is necessary in the usual interchange of traffic] . . ." or permit the collateral to be in any manner encumbered by or through the Railway. Fifth,

each unit of equipment must bear a plate showing the true owner of the same, so that no doubt remains as to who holds the title.

INCOME FEATURES

Features of the income position of equipment trust certificates are in large measure a reflection of the security provisions. Default in the interest payments may be used as a basis to deprive the railroad of the right to use the equipment. An illustration of the general strength of the income position of equipment obligations is found in a certain railroad which was in the hands of the receivers for seven years. During the greater part of this period, interest was passed on practically all of the funded debt except the equipment trust certificates.

The cost of financing to the railroad through the use of equipment obligations is relatively low, as may be seen in Table 10, which gives quo-

TABLE 10

COMPARISON OF YIELDS ON EQUIPMENT TRUST CERTIFICATES AND FIRST-MORTGAGE BONDS

(Per Cent)*

RAILROAD COMPANY	EQUIPMENT TRUST CERTIFICATES			FIRST-MORTGAGE BONDS		
	1941	1956	1960	1941	1956	1960
Baltimore and Ohio Railroad..	1.83	3.50	4.65	14.7	4.55	6.73
Missouri Pacific Railroad.....	2.03	3.60	4.65	In default	5.35	6.80
New York Central Railroad...	2.13	3.75	5.35	7.7	5.55	6.59
Pennsylvania Railroad Co.....	1.93	3.40	4.70	2.4	4.00	5.22
Southern Pacific Co..........	2.30	3.40	4.60	10.7	3.95	5.83

* June, 1941, January, 1956, and December, 1960. It should be noted that the comparison is only suggestive because of the wide variation in maturities; for equipment certificates, the yield is the average for all maturities.

tations for the trust certificates of five representative railroads. Equipment obligations are always quoted in terms of yields because of varying maturity dates. For comparative purposes, the yield rate of a mortgage bond of each road is shown. The contrast shows in a striking fashion the emphasis given by investors to the certainty of payment which is characteristic of equipment obligations.

MISCELLANEOUS PROVISIONS

Because of the interstate character of transportation, the railway agrees in the trust indenture to abide by the laws of the various states in which it operates. In addition, various minor items such as the following appear in the indenture: (1) stipulations regarding the form of the bonds or certificates; (2) arrangements for the delivery of the cash deposit and securities; and (3) detailed statement of the duties of the trustee, provision for his resignation, death, etc.

USE OF EQUIPMENT OBLIGATIONS IN OTHER FIELDS

The equipment trust obligation is predominantly a characteristic of railroad financing, but the underlying principle is applicable whenever equipment or personal property retains its identity apart from the fixed plant or real estate. A most unusual example is the case of the Trans Caribbean Air Cargo Lines, which sold publicly 3-year, 7 per cent equipment trust certificates for $150,000 in 1948 to purchase a single cargo plane.[3] While the airline companies have generally used unsecured debentures (often convertible) and stock to finance their development, there are signs that they are beginning to use their equipment as a basis for financing. For example, in December, 1960, Trans World Airlines, Inc., with the assistance of three investment banking firms acting as intermediaries, was successful in raising funds privately by partial use of this means. The aggregate amount of $265,000,000 was represented by the following: equipment mortgage sinking fund notes, due 1971, $92,800,000; equipment mortgage serial notes, due 1961–64, $72,200,000; and interim subordinated notes, $100,000,000.[4] To date, however, public offerings of airline equipment obligations are the exception.

In other industrial areas, the financing of equipment on the basis of serial or installment notes is rather common; but this type of business is handled mainly by banks and various other financial institutions.[5] Seldom, however, is the financing accomplished by the sale of securities to the public, as is true of railroad equipment obligations.

COLLATERAL TRUST BONDS

Another type of obligation which is secured by personal property is the collateral trust bond. In this instance, the collateral consists of stocks, bonds, or other forms of miscellaneous property owned by the issuing corporation. Basically, of course, the first test of any security is found in the financial soundness of the company that issues the bonds. No collateral, or even a mortgage, can take the place of this primary characteristic; indeed, it is possible for a bond to have worthless collateral while at the same time commanding a high investment rating because of its overall financial status. However, the pledging of securities as collateral does

---

[3] *Business Week,* May 29, 1948, pp. 88–90.

[4] See *Investment Dealers' Digest,* January 9, 1961, p. 2. Another example is the Eastern Air Lines which, in early 1961, made arrangements with the Prudential Insurance Company whereby the latter will purchase ten jet airliners and lease them to the former. It is indicated that the obligation of $47,750,000 will be liquidated over a 10-year period.

[5] Raymond J. Saulnier and Neil H. Jacoby, *Financing Equipment for Commercial and Industrial Enterprise* (New York: National Bureau of Economic Research, Inc., 1944).

give to the bondholders control of specific assets in the event of default and may add to the salability of the bonds.

In the ordinary course of business, corporations frequently come into possession of bonds or stocks of other companies. The acquisition of the securities may often be motivated by reasons of control or, on occasion, by the desire to stabilize the sources of materials needed for doing business. Illustrative of the latter are two loans made by the General Motors Corporation to provide an assured supply of steel over a long period of time. In 1950, it made a 15-year loan of $28,000,000 to Jones & Laughlin Steel Corporation and, in 1951, a $40,000,000 loan to the Republic Steel Corporation. In the latter, repayments are related to the amount of steel sold to the General Motors Corporation.[6] However, for our purposes here, the main point to observe is that the General Motors Corporation could at some future date use the obligations of the two steel companies as collateral for a loan of its own. Much more common is the outright ownership of subsidiary companies where the parent company may, if necessary, use their stocks or bonds as collateral for its own financing.

Under the collateral trust device, the securities are deposited with a trustee under suitable indenture; and bonds are issued against the pledged collateral. The company usually retains all the rights of the deposited collateral and receives any interest or dividends accruing while the securities are held in trust. Thus, when the collateral consists of sufficient stock, the control of a subsidiary may still be exercised without being deprived of the use of the funds.

Reflecting the wide and diverse activities of corporations, the pledged security of collateral trust bonds may take the following forms; (1) bonds of other corporations, (2) stocks of other corporations, (3) other obligations of the issuing corporation, and (4) a mixture of collateral.

BONDS SECURED BY BONDS OF OTHER CORPORATIONS

Bonds may be used as collateral when it is desired to substitute an obligation of the parent company for that of the subsidiary. The parent company may make advances to subsidiary companies by purchasing their securities and then replenish its own treasury by the sale of a bulk issue secured by the bonds of the subsidiaries. In this manner, advantage is taken of the more favorable rate which is possible under wholesale financing. Also, the larger parent company may be better known and able to obtain better terms because of its prestige. The following examples are illustrative of collateral bonds secured by the bonds of subsidiaries:

Illinois Central Railroad collateral trust gold 4's, due in 1952, now retired, were secured by the deposit of bonds of controlled lines which are operated by the Illinois Central Railroad.

---

[6] *Business Week,* May 19, 1951, p. 26.

The Louisville and Nashville Railroad Company's secured gold 5's of 1941, now retired, were secured by 5 per cent first-mortgage bonds of the Lexington and Eastern Railroad, 5 per cent general consolidated bonds of the South and North Alabama Railroad, and 4 per cent first-mortgage bonds of the Knoxville and Cincinnati Division.

The use of bonds of controlled companies as collateral was particularly a feature of the early development of railroads. There were numerous short lines, each under a separate corporate organization. By a long process of evolution, these scattered units were welded into larger, coordinated systems by the lease of property, by mergers, or by purchase of controlling interests. Large amounts of bonds were bought by the parent organizations to assist the financing of the subsidiaries or to build up the leased properties. Later, as in the foregoing examples, the acquired securities were used as a basis to recover the capital for operating purposes, either through the issuance of collateral trust bonds or as part of the security for so-called "mortgage bonds."

BONDS SECURED BY STOCKS OF OTHER COMPANIES

Corporations also purchase the stocks of other companies to obtain control or to get into a position to make favorable working agreements. When such action is taken, the parent company may find it advantageous to recover its funds for operating purposes. Collateral trust bonds offer a convenient way to make this recovery without loss of control. The stocks deposited with the trustee may still be voted by the parent company, which will also continue to receive all dividends paid on the pledged collateral. In this way, the issuing corporation maintains any desirable element of control and may be able to profit by paying a smaller amount in interest than it receives in dividends.

Although bonds with stock as collateral appear to be an easy means to obtain control of other companies, their use is restrained by their lack of investment appeal. In effect, they take on the flavor of stocks, even though their security status may be comparable to ordinary debenture bonds. Moreover, the covering indentures may have provisions that require the maintenance of collateral in a prescribed ratio to the bonds outstanding as well as require protection against the issuance of other bonds. These features may be seen in the following examples of collateral trust bonds:

New York Central and Hudson River Railroad Company—Lake Shore collateral trust 3½'s, 1998. These bonds were originally secured by a pledge of $45,289,200 out of $50,000,000 capital stock of the Lake Shore and Michigan Southern Railway Company, with a provision that no further mortgage could be placed on the property without including the collateral 3½'s as a prior lien. As a result of a consolidation with the New York Central Railroad, the bonds now have priority over the latter's consolidated mortgage gold 4's, due in 1998.

Hotel Corporation of America convertible collateral 6's, 1972. These bonds were issued in July, 1960, in the amount of $1,500,000. They are secured by the entire stock of Mayflower Washington, Inc. and Fred Frear & Company—both of which are subsidiaries of the indicated parent organization. The bonds may be converted into common stock of the latter at $5.00 per share to 1963; then at $6.00 per share to 1967; and thereafter at $7.00 per share. Provision is made for a sinking fund to be accumulated on an annual basis beginning July 1, 1962 in amounts which are intended to be sufficient to retire the bonds by maturity. The bonds are also callable—beginning at 106 in 1961 and then at a graduated declining price to maturity.

Pennsylvania Company collateral trust 2½'s to 4½'s (currently 3.20 to 4½ because of retirements), due serially to 1975. These bonds were issued in 1950, and were initially secured by a pledge of the following:

Company	Type of Security	No. of Shares	Total Par Value
Norfolk and Western Railway.........	Common stock	570,000	$14,250,000
Wabash Railroad Co................	4½% preferred	174,000	17,400,000
Pittsburgh, Cincinnati, Chicago and St. Louis Railroad Co................	Common stock	200,000	20,000,000
Philadelphia, Baltimore and Washington. Railroad Co......................	Common stock	295,000	14,750,000
Pennsylvania Railroad Co............	4½% bonds	....	20,000,000

The indenture permits the substitution of collateral; and the company later replaced the bonds mentioned above with 200,000 shares of stock of the Detroit, Toledo and Ironton Railroad, having a par value of $20,000,000. The "fair value" of the collateral must be maintained at 150 per cent of the outstanding collateral trust bonds; as a result of this feature and other pertinent provisions, changes have been made in the collateral since the original pledge.

BONDS SECURED BY OBLIGATIONS OF THE ISSUING COMPANY

Collateral trust bonds may also be secured by other obligations of the issuing corporation itself. The pledged securities may lack market appeal because of undesirable features or may carry an unnecessarily high rate of interest, and a new offering may be used to correct these deficiencies. When the bonds to be used as collateral are secured by a mortgage, the expense and the time-consuming effort of drawing a new mortgage are avoided. There is the further advantage that a company having in its treasury small amounts of unissued or reacquired stocks and bonds of several different issues may consolidate them as collateral for a single, large issue. The larger, collateral issues could then be sold more favorably than the smaller, separate issues.

Bonds of this type have been used by railroads, particularly, in borrowing funds from the Reconstruction Finance Corporation as well as in floating bonds in the open market. The following examples are illustrative:

Baltimore and Ohio Railroad 3½ per cent secured notes, due serially from 1956 to 1965. These notes were placed privately in 1955, and the proceeds were

used to retire collateral trust bonds previously sold to the Reconstruction Finance Corporation. The latter were secured principally by four other issues of the Baltimore and Ohio Railroad itself. The current notes are secured by the notes of 3 other companies, common stock of 16 companies, preferred stock of 6 companies, and by other miscellaneous assets.

Gulf, Mobile and Ohio Railroad Company collateral trust 3¾'s, due in 1968, retired in 1955. These bonds were sold privately and the proceeds used to purchase 16 Diesel electric locomotives, 4 sleeping cars, and 1,500 freight cars. They were initially secured by $2,100,000 cash and $7,000,000 of first and refunding 4's, Series E, due in 1973, of the same company. The latter are secured, along with other series, by a first lien on 2,326.84 miles of line.

Maryland and Pennsylvania Railroad 4 per cent collateral notes, due and retired in 1951. These bonds were sold to obtain proceeds to retire a maturing loan held by the Reconstruction Finance Corporation. They were secured by $100,000 of first 4's, due in 1961, and $500,000 of consolidated 6's, due in 1963, of the same company; and by $200,000 of first extended 5's, due in 1966, of the Maryland and Pennsylvania Terminal Railway Company.

MIXED COLLATERAL

The collateral security underlying bonds may be mixed or consist of a great variety of combinations. It may consist of stocks and bonds alone; or various other arrangements may be worked out, as may be seen in the following examples:

The National Steel Corporation first-mortgage issues—3⅛'s, due in 1982; 3⅞'s, due in 1986; 4⅝'s, due in 1988—are secured by a pledge of the entire capital stock of 5 subsidiary companies; by demand mortgage notes of 2 subsidiary companies; by a first lien, subject to certain exceptions, on the plants owned by the company and subsidiaries; and by other miscellaneous assets.

The Eastern Gas and Fuel Associates' first and collateral trust 3½'s, due in 1965, and the 3¾'s, due in 1974, are secured by a lien on all real estate and rights in real estate and upon all franchises, licenses, patents, etc., as well as by all stocks, bonds, and notes of subsidiaries, with certain exceptions.

The Indianapolis Power and Light Company first-mortgage issues—3's, due in 1970; 3's, due in 1974; 2⅞'s, due in 1979; 2⅞'s, due in 1981; 3⅝'s, due in 1983; 3⅝'s, due in 1986; 4⅛'s, due in 1988—are secured by a first lien on all property now owned or hereafter acquired except for miscellaneous items; by the land and building located at 32–36 South Jersey Street, Indianapolis, and about 28.04 acres of land and a building used for a radio station; and by various goods, wares, judgments, and accounts.

The Crucible Steel Company of America's first sinking fund 3⅛'s, due in 1966, and the 3⅞'s, also due in 1966, are secured by a first lien on substantially all the fixed property and producing facilities now owned or hereafter acquired, by pledge of 50 per cent of the capital stock of 2 subsidiary companies, and by covenants to subject to the lien all capital stock and certain promissory notes of designated wholly-owned subsidiary companies.

The Maine Central Railroad Company's first and collateral 5⅛'s, due in 1978, are secured by a first lien on railroad lines and equipment, and by pledge of $1,000,000 first-mortgage 5's, due in 1958, of the European and North American Railway.

Such examples show clearly the flexibility of financial arrangements as well as the means used to provide security which will make bonds ac-

ceptable to the investing public. They also reflect the difficulties of classifying bonds according to any rigid pattern.

SUBSTITUTION AND RELEASE OF COLLATERAL

Provision may be made to have the collateral fixed for the life of the bonds, or the privilege of substitution may be granted. Assuming a wise selection of pledged assets, the advantage of the first plan is pronounced; but it may not be sufficiently flexible to accommodate the numerous changes which may occur. Flexibility may be desired by management as a means of retaining control over the hypothecated securities. On the other hand, from the point of view of the bondholders, changes in collateral requirements may make it possible to maintain the original relationship between the value of the collateral and the par value of the outstanding bonds.

Examples of the indenture provisions covering the substitution and release of collateral may be taken mostly from the bond issues mentioned previously:

Pennsylvania Company collateral trust 2½'s to 4½'s (currently 3.20's to 4½'s because of retirements), due serially to 1975. A determination of the "fair value" of the collateral must be made each year; and, if it exceeds 150 per cent of the outstanding collateral trust bonds, the difference may be withdrawn. Conversely, if there is a deficiency, the company must deposit additional collateral.

Gulf, Mobile and Ohio Railroad Company collateral trust 3¾'s, due in 1968. The pledged bonds may never be less than 100 per cent, and the bonds and cash combined, less than 130 per cent of the collateral trust bonds.

Northern Pacific Railway Company collateral trust 4½'s, due in 1975. It is simply provided that any pledged security in excess of 150 per cent of the outstanding collateral trust bonds may be withdrawn.

COLLATERAL TRUST BONDS AS INVESTMENTS

A collateral trust bond frequently implies a sort of family relationship, i.e., intercorporate activities of a friendly variety. Because of this background, it behooves the investor to investigate carefully the securities that underlie collateral trust bonds, as well as the provisions designed to provide security in the future. From the viewpoint of the corporation, this type of bond constitutes a legitimate means of financing if the collateral is of high caliber. This requirement is met when collateral trust bonds are used as a means of financing subsidiaries, with senior securities of the latter pledged as collateral. When used primarily for purposes of control, these bonds are likely to be secured by collateral carrying greater risk. Because of these varying conditions, investors need to scrutinize carefully the purpose for which the bonds are issued.

Another approach for the investor, in investigating the security behind a collateral trust bond, is to proceed as if he were considering the

purchase of the collateral itself. All the factors relating to the financial position of a company—liquidity, asset condition, etc.—should be applied to the companies issuing the collateral. If any sizable portion of the collateral seems dubious, the bonds should be purchased only if the general credit position of the company offering the collateral issue is above question, or if the diversification of the collateral offsets other weaknesses.

QUASI-SECURED BONDS

For the want of a better term, certain bonds may be designated as "quasi-secured." These bonds include guaranteed, assumed, and joint bonds. Often these bonds are secured ultimately by liens on real property; but that is not the basis underlying this classification. Instead, the predominating feature to be noted at this time is the existence of multiliability. In other words, some party or parties other than the issuing corporation are also liable for the bonds. Although the security is not in the form of property, it does give added protection to the bondholders. For this reason, these bonds are presented in this chapter instead of in the following one on unsecured funded obligations.

GUARANTEED AND JOINT BONDS

Strictly speaking, a guaranteed bond is one that is guaranteed by a corporation other than the issuing corporation. The value of a guaranty depends primarily upon the comprehensiveness of its statement and the standing of the corporation making the endorsement. Ordinarily, the guaranty is made within the family, being used frequently to help finance subsidiary companies. It is just another method of injecting the credit position of the parent company into the subsidiary.

In the case of joint bonds, two or more companies assume the guaranty of some undertaking having common interest to the participating guarantors. Usually, a subsidiary is organized to undertake the necessary co-operative function; and the bonds issued to finance the project are given market strength through the guaranty of larger, better-known concerns.

Examples of guaranteed and joint bonds are quite numerous. For example, the Mohawk and Malone Railway's first gold 4's of 1991 were guaranteed as to principal and interest by the New York Central and Hudson River Railroad Company and were later assumed by the New York Central Railroad. Showing that a guaranty is only as valuable as the credit of the company assuming the liability, it may be noted that these bonds are currently selling at 60. The Cleveland Union Terminal Company's first 3¼'s, due serially to 1966, are guaranteed jointly and severally as to principal and interest by the New York Central Railroad; the Cleveland, Cincinnati, Chicago and St. Louis Railway Company; and the New

York, Chicago and St. Louis Railroad Company. The Cincinnati Union Terminal Company's first-mortgage Series E, F, and G of 1969, 1971, and 1974, respectively, are guaranteed jointly by seven railroads using the terminal. Monongahela Railway Company's first-mortgage, Series B, 3¼'s of 1966 are guaranteed by the Baltimore and Ohio Railroad, the Pennsylvania Railroad Company, and the Pittsburgh and Lake Erie Railroad Company.

ASSUMED BONDS

While it is common to guarantee the bonds of a subsidiary company, a more direct acceptance of liability is necessary in the event of actual merger. This is accomplished by an outright assumption of the bonds of the company taken over. Often, the guaranty precedes the assumption. Thus, the first gold 4½'s of the Cleveland Short Line Railway were previously guaranteed by the Lake Shore and Michigan Southern Railway Company. Upon the absorption of the latter by the New York Central Railroad, this company took over the guaranty and still later actually assumed direct liability for the bonds. Likewise, upon the merger of the Central New England Railway into the New York, New Haven & Hartford Railroad Company, the latter assumed the first gold 4's of the merged company. To indicate the prevalence of assumed bonds in the railway field, it may be noted that practically half of the issues for which the New York Central Railroad is responsible are assumed.

Because of the frequency of underlying bonds in the railroad field, it is likely that assumed bonds are more common in this area than in either the public-utility or the industrial sector. However, they are by no means exceptional in the latter two groups, since the need for the assumption of the liability is a necessary incident wherever consolidation occurs. An example of such a utility issue is the unification and refunding 6's of 1952 of the San Joaquin Light and Power Company, which were assumed by the Pacific Gas and Electric Company when the latter absorbed and dissolved the former. In the industrial field, the first-mortgage 5's, due in 1948, of the Illinois Car and Equipment Company were assumed on two occasions—first, by the Western Steel Car and Foundry Company in 1926 and, second, by the Pressed Steel Car Company, Inc., in 1936.

QUESTIONS AND PROBLEMS

1. Discuss the relationship between property security and the following: (*a*) Purpose of the debt. (*b*) Amount of the debt. (*c*) Maturity of the debt.
2. Discuss the influence of the following two factors in determining the use and nature of specific security for bond issues: (*a*) general credit position of the issuing company; (*b*) general capital-market conditions.

3. What are the similarities between railroad equipment trust certificates and the promissory notes of individuals purchasing automobiles on the installment plan? How do you account for the difference in rates of interest?
4. Refer to *Moody's Transportation Manual* and summarize the relative amounts of financing of equipment by any large railroad on a private placement and public offering basis; with these facts in mind, discuss the following: (*a*) Why is it good policy to utilize both methods? (*b*) Why is there no need for a trustee when the securities are placed privately?
5. Compare the yield of an equipment trust certificate of a railroad in a weak financial standing with that of a first-mortgage bond of a company having a sound position. Comment on the results.
6. Even though the ratio of the book value of equipment to the outstanding equipment obligations increases with the lapse of time, general economic conditions may determine the real significance of this ratio. Discuss.
7. In one of the few cases "where an equipment trust lease was disaffirmed and the equipment sold was that of Florida East Coast Railway which was placed in receivership in 1931" (*Railroad Equipment Trust Certificates* [Salomon Bros. & Hutzler], p. 19), the certificate holders received $593.54 per $1,000 certificate. Refer to *Moody's Transportation Manual*, and compare this result with the settlement of other security issues.
8. Discuss and evaluate the problems of financing airline companies by the use of equipment obligations.
9. In 1950, the Brown Company issued $16,000,000 of collateral trust bonds, as follows: $13,600,000, 3½ per cent series, due in 1970; and $2,400,000, 2½ per cent notes, due serially 1951–53. The collateral trust bonds were retired in 1955, and, in the same year, debenture 4½'s, due 1975, were issued for other purposes. Refer to appropriate numbers of *Moody's Industrial Manuals* to ascertain all the pertinent facts and evaluate the record of such financing.
10. Why is it not uncommon for public-utility first-mortgage bonds to be secured partially by other collateral? See, for example, the first-mortgage and collateral trust 2⅞ per cent series bonds, due in 1980, of the Union Electric Company of Missouri; also the first-mortgage and collateral trust 4¼'s, due 1978, of the United Gas Corporation.
11. Summarize the arguments for and against the substitution of collateral, from the point of view of the investor.
12. In June, 1960, the Pennsylvania Company issued $35,000,000 collateral trust 5¼'s, due in 1985. The bonds are secured by 1,400,000 shares of Norfolk & Western Railway Company common stock (market value as of May 19, 1960—$138,600,000). Discuss and evaluate the nature of this financing (see *Moody's Transportation Manual* for further details).
13. Discuss the use of common stock as collateral, from the point of view of the investor.
14. Distinguish between assumed and guaranteed bonds.
15. Discuss the relationship between assumed or guaranteed bonds and business expansion.

REFERENCES

Bogen, J. I. (ed.). "Bond Financing and Borrowing," *Financial Handbook*, pp. 494–501. New York: The Ronald Press Co., 1957.

Duncan, Kenneth. *Equipment Obligations*. New York: Appleton-Century Co., 1924.

Fletcher, William Meade. *Cyclopedia of the Law of Private Corporations*, Vol. 6A, chap. 30. Rev. and permanent ed. Chicago: Callaghan & Co., 1950.

Grant, Donald R. "The Role of the Lender in Equipment Financing," *Commercial and Financial Chronicle*, Vol. 191, No. 5920 (January 28, 1960), pp. 13, 45.

Griesinger, Frank K. "Pros and Cons of Leasing Equipment," *Harvard Business Review*, Vol. XXXIII, No. 2 (March–April, 1955), pp. 75–89.

Guthmann, Harry G., and Dougall, Herbert E. *Corporate Financial Policy*, chap. viii. Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1955.

Street, Donald M. *Railroad Equipment Financing*. New York: Columbia University Press, 1959.

Chapter 10 ►

UNSECURED AND MISCELLANEOUS BONDS

PRELIMINARY to our discussion of unsecured and miscellaneous types of bonds, there may be need to remind ourselves that the primary purpose of all forms of securities is to raise capital. As a consequence, the various bond features reflect, in large measure, devices or means that are used to attract investors. At times, it may be felt that specific security is needed to obtain the desired response in the investment market; on other occasions, there may be complete dependence on the general credit of the issuing corporation. Or there may be other attractions—such as the right of conversion into other forms of securities, particularly into common stock. Again, when investors are confronted with adjustments arising out of failure and reorganization, they are virtually compelled to take securities that are mainly the product of expediency. Tradition also plays a part in formulating judgment on the type of security to be issued. These influences will become more apparent as we proceed to discuss the following types of securities: (1) debenture bonds, (2) convertible bonds, (3) income bonds, and (4) receivers' cerficates.

DEBENTURE BONDS

The term "debenture" means "debt"; and in this broad sense, it could be used in connection with mortgage bonds; that is, mortgage bonds could be designated as mortgage debentures. However, financial practice has restricted the meaning of "debenture" to include only those bonds which are not secured by any specific pledge of property. The debenture bond is a widely accepted mode of corporate financing. It appeals to the corporation because the absence of a specific lien gives greater freedom to management and permits the reservation of secured obligations for periods of emergency. In the event of default in interest or principal payments, the bondholders are unable to bring foreclosure proceedings to have the property sold by the court. Instead, the bondholders have re-

course to equity proceedings wherein a receiver is appointed for the protection of the bondholders; but the corporation continues to operate under this receivership for the benefit of all interests.

From the point of view of the investor, the debenture bond has an appeal because, in the last analysis, the general credit or financial position of the corporation constitutes the only assured basis of safety—irrespective of the type of bond. Specific security is of little value if the property lacks earning power, and the extent to which earnings will cover the interest charges provides the real clue for investment guidance. It is for this reason that the awkward but meaningful expression "times interest earned" is a yardstick of universal acceptance in the bond market. In the same corporation, first-mortgage bonds obviously have a preferred position over debentures; but between different corporations, the terms are purely descriptive and convey no sense of investment merit.

Serving in a manner that is somewhat comparable to the after-acquired clause used in connection with mortgage bonds, protective controls of future financial operations are a common feature of debenture issues. They vary from the simple requirement that the company may not create "any lien upon its property without first securing . . . equally and ratably" the existing debentures to the more rigid specifications which must be met before funded debt of any character may be assumed. The restrictions are spelled out with legal preciseness in the indenture, but their nature may be highlighted by the following two examples:

Celanese Corporation of America sinking fund debenture 3's, due in 1965, and the 2.85's, due in 1966, have no restrictions upon new unsecured debt except that the consolidated net tangible assets must equal at least 2¼ times the total funded debt. However, liens may be created only by giving the same protection to the debentures, and dividends on the common stock are subject to certain restrictions.

Food Fair Stores, Incorporated, debenture 3's, due in 1965, and the 3⅝'s, due in 1974, provide that no new funded debt may be created unless consolidated net tangible assets are at least 2 times the funded debt, and net income for any consecutive 12 out of the previous 18 months and for an annual average of 2 fiscal years is at least 2½ times the interest on such debt. Dividends may not exceed net income and may not be paid unless the *net* current assets are equal to 75 per cent or more of the funded debt. The debentures assume an equal lien in the event of a mortgage or pledge of property.

The effect of the control placed in debenture bonds may prove to be of vital concern to the interests of both the bondholders and the corporation. Although designed to protect the former, arbitrary limitation of action may work to their detriment. Sound management and wise expansion of the company are of benefit to the bondholders as well as to the stockholders. Curbing legitimate financing does not necessarily achieve ideal protection; instead, it may check the growth of the corporation or prevent changes necessary to meet competition.

From the point of view of management, restrictive clauses may place

undue emphasis upon the current position at the expense of future opportunities. Nor may the contingencies of future difficulties be anticipated in a way that would permit the freezing of standards best fitted to meet such demands. Seen in retrospect, it is now clear that protective clauses may have impaired the recovery of many corporations in the thirties and that costly legal proceedings were necessary to open the way for the revitalization of the investors' interests. In any event, it is now a common procedure to make provision for modification of the controls by stipulating in the indenture that changes may be made upon approval by the bondholders—usually by a vote of 66⅔ per cent.

USE OF THE PROCEEDS

Debentures are commonly used for expansion or to retire temporary debt which has been incurred for this same purpose. Development of the plant investment naturally takes place over a period of time and suggests the use of interim or short-term financing which can be scheduled to harmonize with the need for funds. Indeed, if long-term funds are procured too far in advance of their utilization, an unnecessary cost is incurred. During the thirties, the commercial banks were not too active in making loans for business expansion purposes; but, in recent years, there has been a vigorous revival of this type of business.

Often, debentures are issued for the joint purpose of repaying bank loans or other debts and to meet the needs of further expansion. Of the many corporations raising funds for such purposes, the following offerings in 1960 and 1961 may be mentioned for the sake of example:

American Gypsum Company, 7 per cent notes, due in 1969, $1,200,000
Amacorp Industrial Leasing Company, 6¼ convertible subordinated debentures, series A, due in 1970, $1,000,000
Chesapeake & Potomac Telephone Company of Maryland, 5¼ per cent debentures, due in 1996, $25,000,000
Melville Shoe Corporation, debenture 4⅞'s, due in 1980, $12,000,000
National Fuel Gas Company, debenture 5⅛'s, due in 1985, $18,000,000
Norwalk Truck Lines, Inc., debenture 5¾'s, due in 1970, $750,000
Northwestern Bell Telephone Company, debenture 4⅞'s, due in 1998, $45,000,000
Texas Electric Service Company, debenture 5¼'s, due in 1985, $12,000,000
U.S. Plywood Corporation, debenture 5¼'s, due in 1985, $25,000,000

Like other types of bonds, debentures may also be used for the refunding of called or matured obligations. There is the usual objective of getting a lower rate of interest or of establishing more favorable terms—maturity, sinking fund provisions, and other miscellaneous features. An example is the Borden Company's 2⅞ per cent debentures, due in 1981, issued in the amount of $60,000,000 at par. About $14,000,000 of the proceeds were used for general corporate purposes; but the balance was used to retire its 1¾ per cent promissory notes, due serially from 1951 to 1956,

and its 3 per cent promissory notes, due serially from 1958 to 1968. The new issue contained a sinking fund requiring annual payments of $1,250,-000 beginning in 1953 and also gave the company the option to make additional annual payments up to $1,250,000. The bonds are redeemable at 102½ during the 12 months beginning March 1, 1951, decreasing to par by March 1, 1978.

When debentures are used to retire debt, a distinction should be made between floating, or truly current, debt and indebtedness that is incurred for the purpose of sound expansion. The funding of floating debt is a practice to be avoided. If a corporation is unable to pay its current obligations, it is not likely that it will be able to meet the fixed charges and sinking fund payments of long-term debentures.

SUBSTITUTION OF DEBENTURE BONDS FOR PREFERRED STOCK

Sometimes debenture bonds are used as a method of financing the retirement of preferred stock.[1] Management may decide in favor of such a revision of financial structure in order to save the difference between the higher rate of dividends and the lower rate of interest which would be paid on bonds. Added incentive is found in the resulting lower federal income tax, since interest, unlike dividends, is an allowable expense. At the same time, the risk is increased by the substitution of a fixed charge, which must be met regularly, for a contingent charge, which may be avoided if the directors so elect. If future earnings prove to be inadequate, default in the interest may occur and cause the company to be placed in receivership. There is the further burden of a definite maturity date when the principal must be retired through one means or another, whereas the preferred stock may provide permanent financing without any fixed time limit.

The risks incurred in switching from preferred stock to debentures suggest caution in the adoption of this policy. The savings made possible by the rate differential do tend to strengthen the current position under normal operations, but only at the sacrifice of longer-term security. Hence, there must be full assurance that careful consideration has been given to the latter, both as to the prospects of stable earnings and as to the ability to discharge the indebtedness at maturity. Assuming these two important prerequisites, debentures may occasionally be substituted to advantage for preferred stock where a high rate exists or where the creation of a sinking fund is required to retire the stock.

---

[1] For example, the Standard Oil Company of New Jersey debenture 3's of 1961 were sold to help finance the retirement of the 5 per cent preferred stock of a subsidiary, the Standard Oil Export Corporation. The Purity Bakeries Corporation sinking fund debenture 5's of 1938 were issued to retire the 7 per cent preferred stock and debt of subsidiaries.

THE DEBENTURE BOND AND THE FIELD OF ENTERPRISE

The debenture bond is a common medium of raising capital in the industrial and public-utility fields, but it has only limited use in the financing of railroads. Undoubtedly, this condition is caused mainly by the predominance of mortgage debt in the latter, which of necessity weakens their open or general credit position. On the other hand, when a railroad has established a financial record of recognized strength, it is able to utilize the debenture method with considerable success. For example, the Union Pacific Railroad Company was able to float a sizable debenture of almost $45,000,000 in 1946 at the favorable rate of 2⅞ per cent with a maturity of 30 years. Also, in 1955, the Illinois Central Railroad sold a 3½ per cent sinking fund debenture, due in 1980, in the amount of $18,000,000 to refund its 6 per cent noncumulative preferred stock and for general corporate purposes.

Debenture bonds also reflect financial moods and may be used by a particular industry when it enjoys public favor, although they lose their appeal under opposite conditions. The nature of the underlying general credit is such that there is marked dependence upon public confidence. In the twenties, the public utilities gained a position of considerable prominence so that holding, as well as operating, companies found it fairly easy to market debenture issues. But during and following the early thirties, they felt the effects of various adverse influences; and there was need to place greater reliance upon mortgage bonds as a means of raising funds. Even here, however, tradition and prestige exercise an influence that may produce opposite results. Outstanding in this respect is the wide use of debentures by the American Telephone and Telegraph Company and its subsidiary companies. Two recent examples of such financing are the $250,000,000 issue of 4¾ per cent debentures, due in 1998, of the American Telephone and Telegraph Company, and the $72,000,000 issue of 5⅛ per cent debentures, due in 1993, of the Pacific Telephone and Telegraph Company. However, there may be resort to mortgage bonds, especially by smaller telephone companies, as shown by the following examples:

Illinois Consolidated Telephone Company, first-mortgage 3's, 3¼'s, 3.85's, and 5¼'s, due respectively in 1975, 1975, 1982, and 1989.

Kern Mutual Telephone Company, first-mortgage 4's—series A, due 1973; series B, due 1975; and series C, due 1979.

La Crosse Telephone Corporation, first-mortgage 3½'s, 3⅜'s, 3¼'s, 3⅞'s, and 4⅜'s, maturing respectively in 1968, 1968, 1975, 1977, and 1983.

Lorain Telephone Company, first-mortgage 3½'s (series C), 3½'s (series D), 3's (series E), 3½'s (series F), 4⅞'s (series G), 4½'s (series H), and 5¼'s (series I), maturing respectively in 1965, 1965, 1975, 1980, 1982, 1983, and 1984.

Norfolk and Carolina Telephone and Telegraph Company, first-mortgage 3½'s, 3⅜'s, 3⅞'s, and 4⅛'s, due respectively in 1973, 1975, 1978, and 1975.

It is not so easy to generalize about the industrial field because of the lack of uniformity in its operations as well as the wide range in the size of different companies. At the same time, it may be observed that many large and well-known industrial corporations have gained considerably in investment prestige since the dark days of the early thirties. Recovering from their shocking lows of that period, then demonstrating unusual vigor during the war years, and continuing with phenomenal development in the postwar prosperity, a wide variety of industrial companies have achieved a pre-eminent status. Indeed, the securities of many industrial companies now enjoy the highest investment rating, particularly where they show long-term performance of merit or occupy positions of vantage in meeting the needs of the Space Age. During the opening years of the fifties, well-known industrial companies were able to issue debentures at rates generally under 3 per cent; more recently, consistent with capital-market conditions, rates of from 4½ to 5½ per cent are fairly typical.

FINANCING TERMS AND THE SPECIFIC CORPORATION

The credit standing and the general reputation of the individual corporation also exercise great influence upon the terms and conditions of

TABLE 11

MISCELLANEOUS DEBENTURE BONDS AND UNSECURED NOTES ISSUED IN 1954 AND 1960*

Name of Company	Amount of Issue	Rate	Term of Issue (Years)
Issued in 1954:			
American Optical Company	$ 2,000,000	3⅜	18
Bell & Howell Company	1,500,000	3¾	15
Blaw-Knox Co.	10,000,000	3½	20
Mercury Manufacturing Company	300,000	4¾	10
Miles Laboratories, Inc.	1,000,000	3⅛	15
Studebaker-Packard Corp.	25,000,000	4	20
Stromberg-Carlson Co.	5,000,000	4⅕	15
Union Carbide & Carbon Corp.	100,000,000	3¾	97
Issued in 1960:			
Loral Electronics Corp.	5,000,000	5¼	20
Metropolitan Telecommunications Corp.	500,000	7	10
Polymer Corp.	2,750,000	5½	15
Northwestern Bell Telephone Corp.	45,000,000	4⅞	38
Solitron Devices	400,000	6	7
Speedry Chemical Products, Inc.	2,000,000	6	15
United Airlines, Inc.	25,000,000	4⅞	25
United States Shell Homes, Inc.	2,500,000	8	15

* Various issues of *Commercial and Financial Chronicle* and *Investment Dealers' Digest.*

debenture bonds, as well as all types of securities. Well-established and widely recognized companies are naturally able to get more favorable

terms than those that are not so well-known. The range of possibilities may be seen in Table 11, which reports the salient facts for a number of debentures and unsecured notes issued in 1954 and 1960.

While the size and term of the issue necessarily influence the rates of interest shown in Table 11, it is likely that the financial standing of the companies is of even greater importance. To illustrate, despite the long maturity of the notes of the Union Carbide and Carbon Corporation, the rate is one percentage point less than that on the 10-year notes of the Mercury Manufacturing Company; as indicated, both issues were floated in 1954. A similar pattern of differences appears in the 1960 offerings. For example, the debentures of the well-established Northwestern Bell Telephone Corporation bear a rate of 4⅞ per cent as compared with 8 per cent on the debentures of the United States Shell Homes, Inc.; again, the former have a much longer maturity. Needless to say, there are various other factors which also cause differences in rates and financial terms, such as: conversion privileges, rights to buy common stock, record of past performance, and even the particular month in which the financing occurred.

THE SUBORDINATION FEATURE

Earlier in this chapter, reference was made to various provisions in debenture bond indentures that protect the related security issues against the issuance of additional bonds of the same type and those having prior liens. At this point, brief reference may be made to a feature that has the opposite effect, viz., the subordination of the rights of holders of securities in favor of those who purchase other different issues at a later date. This characteristic was not unusual in the past when issuing securities pursuant to a plan of reorganizing a company in distress but, in recent years, its use in connection with newly offered debenture issues of a solvent, going concern is fairly common.

The question naturally presents itself as to why investors knowingly would place their funds in bond issues where their claims would be subordinated, or made junior, to other creditors in the event of insolvency of the issuing corporation. First, use of the subordination feature is undoubtedly facilitated by the long period of prosperous business which tends to dim the memory of the woes of depression and by the attractiveness of future outlook which seems to dull the attentiveness of investors. Second, bonds of this type generally carry a higher rate of return to compensate for the greater risk. Third, the feature is most commonly found in debentures which are convertible into stock or which carry warrants to buy stock at a stated price. Under these conditions many investors are willing to make concessions of underlying security in order to obtain the privilege of participating in the potential capital gains available to holders of common stock. Examples of convertible

bonds and those with warrants may be seen in Table 12. At this time, we may confine our discussion to the convertible feature and give attention to the basic nature of warrants in Chapter 19.

TABLE 12

ILLUSTRATIVE SUBORDINATED DEBENTURES OR NOTES

Issuing Company	Amount of Issue	Interest	Term of Issue (Years)
Bonds with conversion feature:			
Collins Radio Co.	$12,000,000	4¾	20
Dayton Rubber Co.	7,500,000	5½	20
Elco Corp.	1,000,000	6	15
Highway Trailer Industries, Inc.	3,000,000	6½	15
Medallion Pictures Corp.	290,000	6½	8
Metropolitan Broadcasting Corp.	6,000,000	6	15
Miles Laboratories, Inc.	8,255,000	4¾	20
Nalley's, Inc.	1,000,000	6	15
Bonds with warrants:			
Anelex Corp.	2,250,000	5½	14
Bevis Shell Homes	1,600,000	9	25
Crown Aluminum Industries Corp.	1,500,000	7½	17
Hydra-Power Corp.	600,000	6½	10
Larson Boat Works, Inc.	300,000	6	4
Teleregister Corp.	6,000,000	6	20
Texas National Petroleum Corp.	6,500,000	6½	15

CONVERTIBLE BONDS

As the name suggests, convertible bonds give the holder the privilege of exchanging his holdings for securities of a different type, usually common stock. This feature may be attached to any type of security, but it is most commonly a feature of preferred stocks and debenture bonds. Its use in connection with the former was discussed in Chapter 6, and brief attention may now be given to its nature when employed as an auxiliary feature of bonds.

Most financial writers tend to regard conversion as a factor that contributes to the retirement of bonds and, for this reason, emphasize this particular quality. Granted that this is the result of conversion, it is likely that more thought is given to the right as a means of facilitating the initial sale of the bonds. It is for this reason that the privilege is almost always attached to debenture issues—not to mortgage bonds in which specific security may be held out as a special inducement to investors. On the other hand, debenture bonds may need some attraction over and above the general credit of a corporation in order to give glamor to their market "dress."

The use of convertible bonds as a means of raising new capital depends in large measure upon conditions in the capital market and the financial appeal of the issuing corporation. With respect to the former, it is neces-

sary that stock prices be reasonably buoyant in order to make the conversion privilege attractive; as to the latter, the outlook for future growth should be promising. The attractiveness of the conversion feature under these conditions may be readily seen in two simultaneous debenture offerings of $60,000,000 each by the Union Oil Company of California in June, 1961. One issue is an ordinary debenture, due in 1986, bearing an interest rate of 4⅞ per cent; the other is of the subordinated type, but is convertible into common stock at $65 per share until June 1, 1966. The latter bears an interest rate of 4½ per cent and matures in 1991. Both issues were offered to the public at the identical price of 100 per cent of par value.

To the extent that the investor attaches significance to the potentialities of conversion, he must, in many ways, use the approach of a speculator. There is the obvious risk of buying such bonds when stock prices are near their peak, and the right of conversion may be of little actual value. For example, the 4½ per cent convertible debentures of the Baltimore and Ohio Railroad were sold in 1930; and the ratio of the exchange of bonds for stock was naturally based upon prices prevailing at that time. Specifically, the exchange price began at 120 in 1931 and increased to 130 for conversions after 1941; currently, the stock is selling around 27¼.[2]

Consistent with their speculative flavor, convertible bonds lend themselves to the financing of new ventures or of lesser-known companies which may show promise of development. Illustrative of new-venture use are the convertible debenture 4's of the Graham-Paige Motors Corporation which were issued in 1946. The funds were for the purpose of developing the new Kaiser and Frazer cars, and the bonds were later assumed by the Kaiser-Frazer Corporation. In the ensuing fifties, security offerings took on even more frills, particularly when issued by lesser-known enterprises. Two examples of such issues sold in 1960 are the following:

New Precision Transformer Corporation—convertible, subordinated 6½'s, due in 1970. Each $100 of debentures had the further right to buy 4 shares of common stock for a period of five years.

Litecraft Industries, Ltd.—subordinated, sinking fund debenture 6¼'s, due in 1980. The bonds were offered on a unit basis—$500 principal amount of bonds and 25 shares of common stock (par $1.00)—at a price of $500.

While convertible bonds are often employed in more or less speculative cases, the conclusion should not be drawn that this is always true. On occasion, companies of recognized financial strength utilize this medium in order to take advantage of market conditions or to encourage indirectly the building of their common stock base. Most prominent in this category is the American Telephone and Telegraph Company, which has floated several issues of convertible debentures over a period of time. Its

[2] In the debt adjustment plan of 1944, these bonds were exchanged on a par-for-par basis for convertible income 4½'s, due in 2010. The conversion price was also changed to $100 per share of common stock.

most recent issue was in 1958, when it sold such bonds having a par value of $718,313,000—a record amount for a single private offering except for the issuance of additional common stock of almost $1,000,000,000 by the same company in early 1961. Bearing an interest rate of 4¼ per cent, the bonds have a maturity of 15 years.

TERMS OF CONVERSION

A common characteristic of convertible bonds is the stiffening or the elimination of the right of conversion after the lapse of a specified period of time. In effect, the corporation says to the bondholders: "Come in early and share the full risk and don't wear out your welcome." For example, the 4¼ per cent convertible issue, due in 1987, of the Phillips Petroleum Company has the following conversion rights: from date of issue in 1957 to 1967 at $50 per share; 1967–72 at $55 per share; 1972–77 at $60 per share; 1977–82 at $65 per share; and thereafter at $70 per share. In the convertible 3⅛'s, due in 1982, of the Standard Oil Company (Indiana) the conversion right is limited to approximately the first five years of the life of the bond. Specifically, the bonds may be converted until October 1, 1962 on the basis of $46 principal amount of the debentures for one share of stock. As is the case with convertible preferred stock, convertible bonds are usually protected against the dilution of value which may result from stock dividends and the splitting of shares, reflecting, once again, the anticipation of change in the financial scene.

MARKET PRICE OF CONVERTIBLES

Because of the fact that convertible bonds may be exchanged for stock, their respective prices necessarily reflect interacting influence under favorable stock market conditions if the performance of the particular corporation invites attention. Indeed, under these circumstances, convertible bonds generally sell at a premium over their conversion values as well as their strict, investment values.

Illustrative of the former feature are the convertible debenture 5's, due in 1984, of Spiegel, Inc.; in September, 1960, the bonds sold at $120.00 compared with a conversion value of $114.10 (3.26 shares per $100.00 bond face value). The spread between normal investment value and conversion or market value may be seen by a comparison of the Detroit Edison Company's general and refunding 3¼'s, due in 1980, and its convertible debenture 3¼'s, due in 1969. In July, 1960, the mortgage bonds were selling at 83, while the convertibles were selling at 174.

The prices of a convertible bond and the stock into which it is convertible display sympathetic reaction only when the stock price is at a level which is sufficiently high to make the conversion attractive. For example, the current price of the stock of the Baltimore and Ohio Railroad

can have no present effect on the bonds because conversion would cause a heavy loss to the investor. The results of such a conversion, assuming a purchase of the bonds at their current price, would be as follows:

Cost of bond at 70	\$700.00
Conversion of bond would give 10 shares, which at their current price of 27¼ would be worth	272.50
Loss by conversion	\$427.50

The foregoing examples are illustrative of the following general principle: The price of the stock into which a bond is convertible has little effect upon the price of the bond until the stock reaches a point equal to or above the expressed price of conversion. In other words, the upper limit of the price for bonds is responsive to the price of the stock into which it is convertible. If, however, the stock price is below the conversion figure, the market price of the bond is determined in the same manner as other types of bonds by the yield and the credit standing of the company. Under these circumstances, the price of the bond may be above or below par, depending upon market conditions and the outlook for the particular bond.

Once the price of the stock approaches or exceeds its conversion price, an immediate and close relationship should exist between the price of the bond and the stock for which it may be exchanged.[3] This may be seen in the market action of the convertible debentures of Spiegel, Inc. to which previous reference was made. In January, 1960, the respective high prices of the bonds and stock were 141¾ and 43¼; in December of the same year, the comparable figures were 150½ and 46⅜. The prices of the bonds deviate slightly from the nominal conversion value on both dates, but minor differences are not unusual when the trading is not heavy; also, they may reflect brokerage and other incidental costs of making the transfer from bonds to stock.

SUMMARY COMMENTS ON CONVERTIBLE FEATURE

The use of the convertible feature reflects particularly a response to the moods of the capital market. Present are the familiar qualities of *style* or *fashion* that exist in any product—temporary popularity invites quick response in volume but there is an absence of assured permanence. In the case of convertible bonds, they come into favor in times of prosperity and lose their appeal in periods of adversity.

Because of the high level of business profits in recent years many opportunities have been made available to investors and speculators to make capital gains. Under the circumstances, convertible bonds have

[3] To state the general relationship between the bond price and the stock price, after the latter has moved above its conversion price, the price of the former should approximate a figure that may be determined algebraically by the formula: Market price of bond *equals* par of bond *times* ratio of market price of stock to stated value of stock offered in exchange.

unusual attraction because they permit participation in profits of this type. Other bonds may decline in value as a result of rising interest rates or commodity prices, but convertible issues respond to movements in the stock market. Again, there is the alluring thought that the latter provide a convenient hedge—in prosperity, convertible bonds advance in price along with their companion stocks and, when stock price movements are adverse, the rights and benefits of a bond position may be retained by not exercising the conversion privilege.

Business management has not been slow in taking advantage of these conditions. Convertible bonds have been issued in large volume, and usually on a basis that assures their conversion into stock. Generally, the right to call the bonds is included and, at the opportune time, the bonds are called for redemption. Rather than redeem his bonds at the call price, the investor has little alternative other than to convert the bonds in order to preserve the profits that may be realized by conversion into stock.

Normally, voluntary conversion is sufficient to bring about the transition from bonds to stock, and the call feature is simply a convenience or facility to clean up the tag ends of convertible bonds still outstanding. A dramatic example of the effectiveness of conversion is the American Telephone and Telegraph Company; its capital stock increased from $2,985,417,500 at the end of 1950 to $7,154,342,000 at the close of 1959, with only a single public offering of its stock of approximately $550,000,000 in the interim.

INCOME AND ADJUSTMENT BONDS

Income and adjustment bonds are usually the instruments of necessity rather than of normal financial operation. Traditions arising out of the former feature probably deter their use for the latter. Since interest is paid on such bonds it is deductible for tax purposes, and, for this reason alone, they should have considerable appeal to management as compared with preferred stock where the dividends are not deductible for computing tax income. However, it is likely that the lack of general acceptance of income bonds by investors discourages their use. The speculative nature of the bonds may be illustrated by the subordinated income debenture 6½'s, due in 1985, of Southwest Forest Industries, Inc. The offering was made in June, 1960, in the principal amount of $12,000,000. The price to the investor was $70, of which the company received $66.25 (the difference being mainly for sales commissions). The interest is cumulative, and an annual sinking fund is provided in amounts equal to 50 per cent of the net income in excess of $2,000,000.

An example of the use of income bonds to effect tax savings is the exchange of preferred stock for such bonds by the Chicago, Milwaukee, St. Paul and Pacific Railroad Company in 1955. Specifically, it issued income debenture 5's, due in 2055, in exchange for preferred stock on a

par-for-par basis. It was estimated that the savings in taxes would amount to $1,560,000 per year; after allowance for the sinking fund requirement of $300,000 annually, it was indicated that the net savings would equal $0.60 per share of common stock.

Because of the limited use of income bonds for normal financing, our discussion will be directed mainly to their nature and their adaptability in effecting corporate reorganizations. The terms "income" and "adjustment" are used interchangeably or may be used in combination in designating issues of this type. The interest is paid only if earned, a feature accounting for the name "income." The term "adjustment" is usually the result of the following characteristics:

1. The bonds are used for readjusting the capital structure.
2. Frequently, during the first few years after the reorganization, the interest payment may be only a fraction of the stated rate. However, the payments are generally increased and gradually adjusted to the nominal rate.

TABLE 13

EXAMPLES OF INCOME AND ADJUSTMENT BONDS*

Name of Company and Issue	Date of Issue	Date Interest Became Cumulative
Atchison, Topeka & Santa Fe Railway Co. adjustment gold 4's of 1995	Dec. 12, 1895	July 1, 1900
Chicago, Milwaukee, St. Paul & Pacific Railroad Co. 4½ per cent convertible income, Series B of 2044	Jan. 1, 1944	(Cum. to 13½%)
Hudson & Manhattan Railroad adjustment mortgage income 5's of 1957	Feb. 1, 1913	Jan. 1, 1920
Missouri-Kansas-Texas Railroad Co. cumulative adjustment mortgage gold 5's of 1967	Jan. 1, 1922	Jan. 1, 1925
Spokane International Railroad income 4½'s of 2013	Jan. 1, 1940	(Cum. to 13½%)
Third Avenue Railway Co. adjustment mortgage income gold 5's of 1960†	Jan. 1, 1910	Jan. 1, 1913

* *Moody's Manual of Railroads.*

† Pursuant to a reorganization plan in 1956, these bonds were exchanged on the basis of 15 shares of stock of Fifth Avenue Coach Lines, Inc., for each $1,000 bond.

The interest on income bonds may be cumulative or noncumulative. The more common practice is to place the issue on a noncumulative basis during the first few years; and later, when the achievement of a more stable position is anticipated, the bonds are put on a cumulative basis, which may be limited or unlimited.[4] Of the issues shown in Table 13, 2 are on a limited cumulative basis while the remaining 4 provide for the accumulation of interest without limit. Considering the varying dates of

[4] See *Barron's*, February 25, 1952, p. 11, for analysis of 38 railroad income bonds; of these, 6 are noncumulative and 32 are cumulative. Of the latter, 7 are fully cumulative and 25 have limited accumulation ranging from 4 per cent to 25 per cent.

issue of the bonds, there is surprising uniformity of treatment, which probably arises from the common reason for issuance—a state of failure.

Occasionally, income bonds are also made convertible. Two of the issues in Table 13 provide for conversion as follows:

Railroad Company	$1,000 Bond Convertible into—	Time
Chicago, Milwaukee, St. Paul & Pacific Railroad Co.	Common stock at $100 per share	No limitation
Missouri-Kansas-Texas Railroad Co..............	Series A, 7 per cent preferred stock, par for par	Prior to Jan. 1, 1932

The inclusion of the privilege of conversion has much merit because it offers potential relief from the original sacrifices resulting from failure and reorganization. The opportunity for profitable conversion may be very remote; but if profitable operation should occur, the bondholders affected by the reorganization and resulting adjustment would be able to share in the profits and reduce the losses suffered in the preceding reorganization.

The imposition of a sinking fund may strengthen the general standing of income bonds. Of the issues described in Table 13, only two have this feature; but the provision is effective only if net earnings are realized and the charges are not cumulative. The question as to whether this class of bonds should feature a sinking fund more generally may be considered. The inclusion of this safeguard may be of much value to the investors called upon to accept these bond issues; but, on the other hand, there is doubt whether it is wise to saddle a financially embarrassed corporation with such a rigid requirement. However, it may be observed that most income bonds do have a sinking fund requirement of some type.[5]

In rare instances, income bondholders may be given the right to vote, the privilege ceasing after the interest payments have been restored to a normal basis. To permit voting is not unlike the right accompanying many issues of preferred stock, when the right to vote is gained upon the failure to meet the dividend payments. At the same time, the income bondholder is essentially a creditor and, of course, retains his priority over the preferred and common stockholders in the event of liquidation.

While we have placed income and adjustment bonds in the unsecured and miscellaneous category, it should be observed that they may have mortgage security. For example, the income mortgage 4½'s of the Spokane International Railroad, due in the year 2013, constituted its only mortgage debt. In 1955, they sold as low as 75¼ and, in 1960, were retired

[5] *Ibid.*; of the 38 issues, all except 9 have a sinking fund requirement.

at their face value plus accrued interest. Again we have an illustration of the difficulty of establishing any rigid classification of securities.

SPECIAL INVESTOR AND PUBLIC INTEREST IN INCOME BONDS

In many respects, income and adjustment bonds are clothed with a peculiar investor and public interest which is not present in other types of bonds issued by normal, going concerns. The latter are purchased voluntarily in the open market and are on a strictly *quid pro quo* basis. In contrast, income bonds are usually obtained under conditions where only limited alternatives are present; and the discretion of the investor is affected by his losses arising from failure. Under these circumstances, the public interest may dictate that securities of the income and adjustment type contain provisions that would permit investors to share in future gains as a partial offset to past losses. In addition, there should be every assurance that other rights of investors, such as priority of position and a voice in control, cannot be easily avoided or by-passed. Fortunately, there is now less opportunity for such abuse of investors in distress because laws have been enacted that require formal approval of reorganization plans by regulatory bodies.

RECEIVERS' CERTIFICATES

Receivers' certificates are issued by receivers who have assumed active management of corporations that have failed. It is obviously impossible to accommodate a company in distress by means of normal financing, and special privileges are necessary if the receiver is to succeed in the task of rehabilitating the enterprise. Not only is this required because of the weak credit position of an insolvent organization, but the efficiency of the operating structure is also reduced to a low state. As a prelude to the fateful hour of failure, private management depletes the inventories and expends a minimum for the maintenance of plant. Consequently, one of the first tasks of a receiver is to place the business on a basis so that it can operate normally. To do this, financial media must be created which will enable the receiver to raise funds despite the impoverished condition of the company.

To make it possible for the receiver to raise funds, a moratorium is placed upon the private obligations previously outstanding; and the receiver is given authority by the court to issue certificates with priority of claim over some or all of the outstanding liens. Such special dispensation is made possible legally by virtue of the fact that the title to all property rests, in a sense, in the court, which may therefore order preferential treatment of holders of receivers' certificates. From a financial and business point of view, the priority of claim is equally necessary because of the impossibility of raising funds by less drastic measures. Obtaining

new funds is advantageous to the existing security holders, since added capital may be necessary if any of the existing investment is to be recouped. For this reason, receivers' certificates usually outrank the issues in default and follow any issues which may still be current or which appear certain to pull through unimpaired.

Receivers' certificates are usually issued for a short term because it is anticipated that they will either be liquidated or be exchanged for new securities upon the successful reorganization of the company. A limited maturity is also in keeping with the types of expenditures usually made by the receivers, viz., for wages, for materials, and for the maintenance of plant. When capital expenditures of long life are essential to the rehabilitation, it may not be unreasonable to issue certificates having extended maturities. However, certificates are not issued often for capital expenditures other than for the completion of projects undertaken prior to the receivership.

Because of the limited life and the priority of claim, receivers' certificates usually carry a high investment rating. The holders may not be paid off in cash, but they will usually receive senior securities in the reorganized company. The reorganization plan of the Wabash Railroad Company sets forth a typical treatment for receivers' certificates. In the plan of reorganization which became effective on January 1, 1941, five issues of receivers' certificates are listed, four series being held by the Reconstruction Finance Corporation and one by banks. The first series, second series, and serial certificates held by the RFC received 75 per cent of the principal in new 30-year first 4 per cent bonds and 25 per cent in 40-year income A 4 per cent bonds. The Series A (held by the RFC) and Series B (held by banks) certificates received 37.5 per cent of the principal in first 4's, 12.5 per cent in income A 4's, and 50 per cent in serial collateral notes bearing 1½ per cent interest and maturing over a 12-year period. Accrued interest on the receivers' certificates was paid in full in cash.

To appreciate the comparative treatment of the mortgage bonds, it may be noted that the first 5's of 1939 received 85 per cent of the principal in first 4's and 28.33 per cent in income 4's; however, only about 16 per cent of the back interest was paid. Less favorably situated bonds naturally received even less favorable treatment, income bonds and preferred stock being exchanged for all the principal and most of the accumulated interest. However, the Wabash–St. Charles Bridge Company first 4's were undisturbed. Analyzed as a whole, it appears evident that the receivers' certificates occupy a position of definite priority.

The use of receivers' certificates also casts another ray of light upon the public interest in private corporations. Private management is presumed to deal equitably with the rights of investors as long as the corporation is operating normally; but in the event of failure, the court intervenes. It may be contended that this is caused solely by the possible conflict of rights which is more or less inevitable in time of distress; but

this, in turn, means that such a conflict would affect the public interest. In addition, it is reasonable to believe that the public gains more by constructive rehabilitation when possible than by drastic liquidation, in which event the public has an interest in promoting the former. To do this, receivers' certificates are given a right of way over other obligations.

QUESTIONS AND PROBLEMS

1. "The ratio of net worth to indebtedness is an important factor that should be considered in determining whether bonds should have specific security." Discuss.
2. Discuss the importance of specific mortgage security (*a*) as a factor of safety and (*b*) as a feature of psychological appeal in the sale of bonds.
3. "Debenture bonds which have a protective clause which provides that other debt may not be assumed unless the debentures have equal security are, for all practical purposes, first-mortgage bonds." Discuss.
4. Give examples of unsecured bonds which, in your opinion, constitute a safer investment than the secured bonds of other companies. State your reasons.
5. Why are railroads and public utilities generally in a less favorable position to issue debenture bonds than industrial companies? Does the point raised in the first question have a bearing?
6. Refer to *Moody's Public Utility Manual*, and note the terms and conditions of the mortgage and debenture bonds of the Commonwealth Edison Company. Comment on the comparative rates and other features of these bonds.
7. In 1960, the Keyes Fibre Company offered to its common stockholders the right to buy \$10,000,000 of 5¼ per cent subordinated debentures, due in 1985. Comment on the following additional features of these bonds: (*a*) Attached warrants permitting the purchase of five shares of common stock (for each \$100 of debentures) after June 1, 1961, at prices ranging from \$18 to \$25 per share. (*b*) The right to convert the bonds after a period of five years from the date of issuance. (*c*) Noncallability of the bonds for a period of five years from the date of issuance.
8. Discuss the merits of generally deferring the redemption privilege for a given period, such as five years.
9. Discuss the conversion feature as a factor bearing upon the sale of bonds.
10. Discuss the position of an investor in a convertible bond that is callable. Also analyze the advantage to management.
11. The Radio Corporation of America recently called for redemption its 3½ per cent convertible debentures, due in 1980. (*a*) It was reported that this action would bolster the equity ratio and permit more flexibility for future financing. Comment. (*b*) Ascertain the prices of the bonds and the stock at the time of the call and consider the position of the bondholders.
12. In 1955, the Bethlehem Steel Corporation issued its 3¼ per cent debentures, due 1980, at a subscription price of 100. (*a*) On a when-issued basis, the bonds quickly commanded prices of 113 bid and 113½ asked. Why would the bonds rise in price so quickly? (*b*) The bonds are convertible, callable and have a sinking fund requirement. Discuss the significance of each of these features. (*c*) The bonds are convertible into stock until 1965, beginning at a price of \$140 to 1957, and increasing \$5 per share every two

years thereafter. Why is a limit placed on the period of conversion? Why does the conversion price increase as indicated?

13. How are convertible bonds protected against the possible dilution of common stock? Does conversion itself tend to dilute the value of the stock?
14. What are the differences between income bonds and preferred stock?
15. Why do the Atchison, Topeka & Santa Fe adjustment 4's of 1995 have such a high investment rating?
16. How do you justify giving receivers' certificates priority over bonds previously outstanding?

REFERENCES

BOGEN, J. I. (ed.). "Bond Financing and Borrowing," *Financial Handbook*, pp. 504–13. New York: The Ronald Press Co., 1957.

COBLEIGH, IRA U. "Open Season for Convertibles," *Commercial and Financial Chronicle*, Vol. 182, No. 5460 (September 1, 1955), p. 4.

FLETCHER, WILLIAM MEADE. *Cyclopedia of the Law of Private Corporations*, Vol. 6A, chap. 30. Rev. and permanent ed. Chicago: Callaghan & Co., 1950.

GUTHMANN, HARRY G., and DOUGALL, HERBERT E. *Corporate Financial Policy*, chap. ix. Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1955.

JOHNSON, ROBERT W. "Subordinated Debentures: Debt That Serves as Equity," *The Journal of Finance*, Vol. X, No. 1 (March, 1955), pp. 1–16.

LEVY, GUSTAVE L. "Arbitrage in the Corporate Bond Market," *Commercial and Financial Chronicle*, Vol. 182, No. 5466 (September 22, 1955), p. 4.

ROBBINS, SIDNEY M. "A Bigger Role for Income Bonds," *Harvard Business Review*, Vol. XXXIII, No. 6 (November–December, 1955), pp. 100–14.

SAKOLSKI, A. M. "Debentures," *Encyclopaedia of the Social Sciences*, Vol. V. pp. 29–30.

PART III ►

Promotion, Capitalization, Ownership, and Management

Chapter 11 ►

PROMOTION AND DEVELOPMENT OF NEW ENTERPRISE

KEEPING IN mind the nature of the corporate structure and the variety of securities it allows, we may now give attention to the promotion and development of new enterprise. The newly created corporation, dwarfed by comparison with the giant companies of our day, may have a depth of meaning which is easily overlooked. In brief, it has *social* as well as *business* significance. Not only is it symbolic of the freedom of enterprise, but, also, it serves to maintain the vigor of our economy. Newness has a way of generating vitality, while maintenance of the status quo allows the corrosive effects of age to take place. Indeed, even existing companies must be in constant search of new methods and products to preserve their place in the economy.

THE CURRENT SCENE

The dramatic achievements of research and science in recent times have made a profound impression upon our society. Most of us lack the ability or knowledge to understand the technical nature of the developments, and we may also fail to appreciate their relationship to business processes. Even so, it is clear that there are powerful currents of interaction which inevitably have shaping and determining influence of mutual significance. On the one hand, there is obvious need for the financing and business management of electronic, missile, and other forms of advancement; on the other hand, such influences generate new business and affect the welfare of existing firms. One of the notable features of our economy during the past two decades has been its capacity to promote and absorb the marked changes that have taken place.

In many instances, governmental contracts have established the basis or assurance which has enabled new enterprise to take root and prosper. Possibly less obvious, but more significant, have been the workings of the

private economy. For established companies, it is comparatively simple to divert funds for research and development, but, for new organizations, the task of getting business under way is much more difficult. It is our purpose in this chapter to give consideration to the various facets of such promotion.

NATURE OF PROMOTION

In simple terms, promotion means the initiation and organization of business enterprise. Clothed in academic dress, it conveys a sense of great proportions; appraised in its practical setting, it consists of a fast-moving procession of new businesses which are organized for the purpose of making a profit. As stated in an earlier chapter, thousands of new corporations are chartered annually; and, for the most part, they represent new ventures. Possibly the businesses are not new, but often there are new owners who wish to promote and operate a company of their own. In many instances, entirely new projects are created—some starting on a fairly sizable scale, such as in television and prefabricated housing, but many more as small companies manufacturing specialty products with three or four employees.

All too frequently, possibly in most cases, there is no studied promotion in the best sense of the word. Instead, ideas are put into effect in a haphazard manner without any real analysis of the venture. There may be compliance with the legal formalities which are required in the formation of any corporation, whether it be large or small; but the enterprise is the product of enthusiastic outburst more than measured action. Most of these ventures are beyond the province of our study, since they represent incidental and casual activities of individuals and do not have any real connection with our subject—the financing of corporations.

SCOPE OF ANALYSIS

Our consideration of promotion is motivated primarily by the fact that it represents the beginnings of corporate life and sets the stage for the financial pattern. No study will be made of those processes of promotion which are largely of a nonfinancial nature, such as engineering investigations, plant location and layout studies, market analyses, legal findings, and a lot of "leg work" which is common to all forms of new venture. Rather, we shall give major attention to the financial factors that are of immediate and ultimate concern. The early need for funds to finance the development of any project is obviously a matter of life or death and, indeed, promotion often ceases or proceeds on account of this one element alone. The transition from a "project" to a "going concern" is a crucial transformation, and its successful accomplishment depends upon the sufficiency of the "carrying power" provided by capital. We

may also note that the fulfillment of this latter function is ever present throughout the life of business enterprise; in brief, the vital role of finance is to nurture and sustain the physical operations. Confining our present analysis to the promotion of new enterprise, we may now evaluate the following features: (1) the economic function of promotion, (2) the risk element, and (3) the sufficiency and nature of the financing.

ECONOMIC FUNCTION OF PROMOTION

Several perplexing questions arise in classifying the function that is performed by the promoter in the economic order. Classical economics recognizes four productive factors: land, labor, capital, and the entrepreneur. The free-lance nature of promotion makes it difficult to place it exclusively under any one of these headings. However, considered in the light of the objectives and functions of the promoter, his actions are basically of the entrepreneurial type—the general guidance or direction of industry. The classical theory does treat the function of the entrepreneur as being continuous in nature and may seem to exclude the promoter because of the roving character of his activities. However, economic theory is formulated mostly on the basis of static conditions, thereby making it difficult to classify dynamic actions. Hence, if the function of the promoter is viewed realistically, it would seem proper to regard him as a special type of entrepreneur who exercises a distinct influence on the direction of business.

Despite the foregoing, we should note that unlike normal management which copes with the problems of an existing market, the entrepreneur often anticipates wants of unknown dimensions. Under these conditions, there is not only a difference in the measurement of the possible outflow of goods or services, but, also, there may be a wide range in the accompanying risk. It is much more difficult to estimate the capital outlays, the costs of production, and the profit potential for new products than it is for goods with a known or measurable market. At the same time, successful innovation may play a vital role in contributing to sound growth of the national economy.

Under today's conditions many of the functions of promotion of the past have become an integral part of the modern business organization with its well-planned research facilities. Some two or three decades ago, research was commonly regarded as a luxury that could be afforded only by large corporations, but now it is deemed to be a common necessity as a means of keeping pace with a fast-changing economy. Many companies, however, elect to procure such services on a consulting basis and have contractual arrangements with specialized firms which confine their activities strictly to research and exploratory work.

To some degree, scientific and technological developments have also given life to the promotion of entirely new and separate companies. Par-

ticularly is this true of the electronics industry with its multitudinous needs for a variety of accessory products. Many scientific and technical items are uniquely dependent upon the abilities of specialists who may elect to take the risks of promoting their own business. To carry out the latter, there is resort to financial interests who have experience in the development of business and the raising of capital.

It should also be noted that the increasing complexities of our society seem to compel greater use of government and its facilities to perform many of the broad functions of promotion. The most dramatic example, of course, is atomic development, but there is a wide variety of other activities of a pioneering or exploratory nature. In many instances, private enterprise is unable or unwilling to assume the risk, and often the initial cost of development or the later costs of production may be deemed excessive to meet the rigors of competition.

Irrespective of whether the development of new products and services is sponsored by government or private enterprise, it should be appreciated that some incidence of loss is inevitable. In government projects, various political factors tend to favor popular response rather than profit result and, consequently, the schedule of rates may not be sufficient to cover the costs. In the private area, there may be exploitation of the opportunity "to get while the getting is good," without sufficient reckoning of market conditions that follow the period of early development. At the same time, we can never escape the realization that losses may be legitimate and necessary. While they constitute a sacrifice on the part of the individuals affected, they also represent a form of subsidy which may be necessary to get industry started. All too frequently, subsidies are associated entirely with the exchequer of the government; but it is likely that unintended contributions of investors have afforded the real basis for much industrial pioneering and development.

A recent example of the absorption by an existing company of losses of the promotional type is the abandonment of the Edsel car by the Ford Motor Company. If it had been produced by a new and independent firm, the losses would obviously have been apparent; instead, they were absorbed by the stockholders of the Ford Motor Company and regarded as part of the cost of doing business.

THE RISK ELEMENT

All businesses involve a degree of risk, although it is less prominent in the established, going concern. Here it is moderated or at least given identity by the test of performance, and the uncertainties are less vivid. However, in the development of a new enterprise, risk is the cardinal factor to be faced by the promoter. On the one hand, there are the pressures of competition in the market; on the other, there are many unknown problems which accompany the building of a new organization. Only by

obtaining sufficient capital of the proper type is the new enterprise able to meet these risks as well as to jump the hurdle from venture to going concern. It is for this reason that the success of promotion is usually found in the availability of financing.

Significantly, too, risk is the key to all financing, whether it be on behalf of government or of private enterprise. There may be times when surplus funds or abnormal conditions seem to belie this basic premise; but, in the long run, its axiomatic character must be apparent. In turn, it is obvious that the prospects of reward must vary in direct ratio to the risks if capital is to be attracted. Under the circumstances, a new enterprise must be able to give promise of more than ordinary return if it is to succeed in raising the necessary funds.

THE LURE OF CHANCE

Chance has familiar meaning and generates well-known reactions; even remote odds contain the spark of hope. It is likely to create a response out of proportion to its own limited worth. For example, in early 1955, the General Electric Company announced that it had produced a synthetic diamond. Diamond users described the innovation as "revolutionary" and "the biggest development to hit the industry."[1] The financial response was equally dramatic—on the day following the announcement, the stock of General Electric opened at 51, reached a high of 55¼, and closed at 54⅛ for a net gain of 3⅛. Here was chance at work—a single stone created such emotional speculative response that, in one day, the stock of the company increased in market value by an aggregate amount of $270,814,431.

In December, 1954, the stock of the Baldwin-Lima-Hamilton Corporation reached a low of $10; shortly thereafter, rumors spread that the company had "atomic age possibilities" and, in the spring of 1955, the stock reached a high of 24½. There followed a reduction in the dividend rate, and the price of the stock at the close of the year was 14⅞. Once again, chance had produced results out of proportion to its worth.

Lacking the record of an established enterprise, a new company in its search for capital naturally gives even greater stress to the appeal of chance. The human urge for taking chances has resulted in spectacular rewards as well as heavy losses; the former are long remembered and, probably fortunately, the latter are forgotten. For this reason, and especially in periods of sustained prosperity, the public response to new ideas or proposals is likely to be enthusiastic. Promoters and security-selling interests quite naturally take advantage of this condition by making easy promises and liberal predictions; for example:

GET IN ON THE GROUND FLOOR NOW for BIG PROFITS with a stock of the highest potential imaginable. BUY CROWN URANIUM NOW.

[1] *Wall Street Journal,* February 16, 1955, pp. 1, 20.

. . . DON'T WAIT for more rises to occur in this phenomenal stock before you decide to buy. If you have already bought Crown . . . we readily recommend buying additional shares of this commodity. This stock should go higher and higher. WE KNOW . . . we've carried Crown through to better than DOUBLE ITS ISSUE PRICE of 10¢ since February 7th, 1955. HUNDREDS OF CLIENTS, acting on our advice, have purchased Crown Uranium and each day more and more demands for this fabulous stock reach this office."[2]

The uranium stock just mentioned is one of many that have been offered to the public in recent years. For example, some 34 offerings were filed with the Securities and Exchange Commission in the period from August 12 to December 13, 1955, alone.[3] Since the amount of capital sought in each instance is $300,000 or less, the purpose of the filing is for notification only, and the securities need not meet the full requirements of registration. Of the 34 issues, 10 had a par value of less than $0.10 per share; 11, a par of $0.10; 5, a par of $0.11 to $0.50; and 8 had a par value of $0.51 to $1.00. In the words of another security dealer, "Fortunes will be made and lost in Uranium, just the same as they were in automobiles or oil when these were new, young industries."[4]

Probably reference should also be made to statements of dishonest or fraudulent intent. Since news tends to dramatize the exceptional incident, it is probable that fraudulent promotion is given more than usual attention. However, needless to say, responsible public officials need to be vigilant in preventing dishonest financial schemes. Not only are the savings of innocent investors involved, but, in addition, such scandal serves to undermine the important element of confidence in business generally.

To illustrate the nature of the deception that may be practiced by promoters, the following cases which were uncovered by the Securities and Exchange Commission and the Department of Justice may be noted:[5]

Four individuals operated under the name of A. D. Lowe and Associates and represented themselves as a firm in business over 100 years. Actually, it was organized in 1937 as a means of enticing investors to switch out of securities into whiskey warehouse receipts. Representations were made that the latter could be disposed of at any time and that they would increase in value each month. As a matter of fact, it was charged that the receipts were worth only one-third of what the investors paid.

A group organized the Colorado River Magnetic Black Sand Company, whose securities were sold to the public. It was declared falsely that the company had a magnetic mining machine which had proved successful in ex-

[2] *Wall Street Investor News*, Vol. I, No. 1 (May, 1955), p. 1. (An advisory service of Justin Steppler, Inc., 30 Broad St., New York, N.Y., member of National Association of Security Dealers, Inc.)

[3] *Investment Dealers' Digest* (The Dealers' Digest Publishing Company, Inc., 150 Broadway, New York, N.Y.), December 19, 1955, p. 101.

[4] See *New York Times*, April 3, 1955, p. F3,—advertisement of Tellier & Co. (1 Exchange Pl., Jersey City, N.J.) entitled "Will You Be Holding THE RIGHT URANIUM STOCKS 10 Years From Now?"

[5] See, respectively, Securities and Exchange Commission, *Release No. 2919*, June 3, 1941; *Release No. 2580*, June 10, 1941; and *Release No. 2582*, June 11, 1941.

tracting gold and other precious metals from black sand. Moving to stop this fraud, a United States District Court issued an injunction enjoining "six companies and certain of their officers from violating the registration and fraud provisions of the Securities Act of 1933."

The stock of the Plymouth Cooperage Corporation of Plymouth, Michigan, was sold on statements made by the president of the company and a broker that whiskey and beer barrels were being produced at a profit of $1.00 per barrel. In fact, a large loss was being realized. Representations were also made that the two plants at Plymouth and Cleveland were operating at capacity. Actually, the first plant was operating only 50 per cent of the time, and there were no operations at all at the Cleveland plant. The president of the company pleaded guilty prior to the trial and was sentenced to an imprisonment of 15 months; the broker was given 4 years' imprisonment and an additional 5 years on probation after completing the prison sentence.

THE TEMPERING INFLUENCE OF FACT

It is also true that fact may serve as a sort of "wet blanket" which smothers the imagination and stifles the urge to take a chance. Even the suggestion of factual detail or the reminder of hazards is apt to scare many who would otherwise speculate on the unknown possibilities of a new venture. Furthermore, there can be no known facts about future prospect, since it is largely the product of contingency. Nevertheless, under the provisions of the federal Securities Act of 1933,[6] all corporations are compelled to present a full and complete statement of the facts relating to any major security issue which is sold to the public. The effects upon a new enterprise are particularly severe, as may be observed in the following statement which accompanied the offering of the Class A common stock of the ill-fated Tucker Corporation:

> Attention is called to the fact that the proposed Tucker is a departure from the conventional passenger automobile built in the industry up to the present time. While both mechanical and body design features have been incorporated into a pilot model, tests on such pilot model have not been completed. Prior to mass production of stock cars on an assembly line, engineering and road tests will be run on pilot models now being built. Five substantially similar models are also being manufactured by hand, the assembly line of the Company not having been set up as yet. Tests on the first pilot model are now under way. These tests, which may take as long as three months to complete, may necessitate material changes in engineering design which may result in delay in attaining quantity production.
>
> The Company is aware of the numerous risks and difficulties involved in an enterprise of this nature and emphasizes, among other things, (1) the automobile it proposes to build is radically different from the conventional passenger automobile and presents the possibility of problems with respect to performance and public acceptance, (2) by the time the Company begins mass production of the Tucker a shortage of new automobiles caused by World War II may have been met to a considerable extent by existing manufacturers, (3) that under present economic conditions difficulties may be encountered in obtaining some equipment, materials and parts, (4) that com-

[6] See Chapter 20 for discussion.

petition in the automobile field is expected to be keen, as the Company is entering into competition with seasoned companies having very large resources, established products, sources of supply and sales outlets, and (5) that the Company's operations have been of negligible size to date and the prospective production of automobiles will represent a new activity involving rapid expansion of both operations and personnel.

Under the circumstances the shares of Class A Common Stock offered by this Prospectus are offered as a speculation only.[7]

In the prospectus covering the offering of the common stock of the Ford Motor Company, it is stated:

Factory sales of the automotive industry for the year 1955 were at the highest level ever achieved. This has been attributed to a number of factors including favorable general economic conditions and increased use of consumer credit. Adverse changes in factors such as these, or decreased demand for automotive products attributable to other circumstances, would affect unfavorably results of operations in the industry. The President of the Company recently stated that he was reasonably sure that 1956 would not be as good a year in the automobile business as the record year 1955. Similar views have also been attributed to others in the industry.[8]

Cautionary comments of the foregoing type naturally raise the question as to how far public authority should go to require the expression of opinion with respect to the hazards of the future or the uncertainties of a new venture. The objective of saving individual investors from possible loss is commendable; but, at the same time, it may also have the effect of preventing some from making a profit if the project succeeds. There is also the point as to the ultimate results on the development of new enterprise which would add vigor to the economy and make available new and better products to the public.

ABSORBING THE LOSSES AND SHARING THE GAINS

A realistic appraisal of the failures that are a normal expectancy in the development of new or expanding companies makes it no idle gesture to raise the question as to who will absorb the losses. The theory underlying the Securities Act of 1933 is that investors may be expected to carry this burden provided they are given the facts. Possibly, however, there is a tendency to believe that government may be expected to spur business development by the use of subsidies or special tax concessions.

Resort to government assistance is evidenced by loans to war veterans for business purposes as well as by facilities created to assist small business enterprise.[9] The underlying philosophy undoubtedly stems from a desire to preserve the democratic nature of business, but, at the same time, there is no escape from the incidence of the attendant risk. Resulting losses

[7] *Prospectus*, July 7, 1947, pp. 3–4.

[8] *Prospectus*, January 17, 1956, p. 7.

[9] See Chapter 17.

which are absorbed by government cannot be regarded as a stopping point since it, in turn, must resort to taxes to recoup its outlays. In short, either directly or indirectly, there is little escape from passing the ultimate burden to the individual citizen.

One of the most interesting problems which is involved in getting new companies under way is the sharing of the benefits of successful operation. It is not uncommon for key personnel, as well as investment bankers who handle the sale of securities to the public, to reserve the right to buy stock at a nominal price per share. In the case of Litton Industries, Inc., such options to buy common stock at $1.00 per share existed until January 31, 1960. In November, 1954, a private sale of the stock was effected at $6.00 per share, and, at the expiration of the option, the stock had a market value of $60.00 (closing price as of May 19, 1961—129⅜).

In favor of such privileged subscription rights, it is contended that those who are largely responsible for the success of new ventures are entitled to a large proportionate amount because of the special services rendered, as well as the risk assumed. The reasoning is much the same as that for paying the management of a going concern a large salary or giving officers an option to buy stock in the company at a relatively low, stabilized figure. From another point of view, the opinion is expressed that individual investors carry most of the real risk, yet have an unequal opportunity to share in the profits. Here is the familiar problem of the distribution of income between those who promote or direct and those who labor or invest.

SUCCESS AND FAILURE

While spectacular profits are commonly associated with promotion, it is likely that more ventures fail than succeed. Even in the case of existing companies, a large number fail to show a net return. Of 940,147 active corporations filing income tax returns for the period July, 1957–June, 1958, some 367,211 showed no net income and their combined deficit amounted to $4,187,538,000,[10] and the results should be much less favorable for new enterprises.[11] From this, it must be clear that it is the chance of making a profit more than its assurance which is the driving force in the organization of new businesses. To consider this quality from the social point of view, it may be said that possibly the challenge to meet

---

[10] *Statistics of Income, 1957–58, U.S. Business Tax Returns* (Washington, D.C.: U.S. Treasury Department, Internal Revenue Service, 1960), pp. 14, 16.

[11] On the basis of the number of corporations, in "only 4 of the 15 years preceding World War II were there more 'active corporations' reporting a net *income* than reporting a net *deficit*." See "The Challenge to Leadership," an address delivered before the members of the Jefferson City, Missouri, Chamber of Commerce, November 4, 1946, by Ernest R. Breech, executive vice-president of the Ford Motor Company.

risk imparts a vigor and alertness to private enterprise which is lacking in government-sponsored activity.

The results of business promotion are quite similar to those experienced in personal living, ranging from unfortunate failure to brilliant success. To take a single field of endeavor, we may note the performance in the automobile industry. The *Automotive News* reports that out of the 1,492 makes or names of cars of record, excluding commercial vehicles, there are only 27 survivors. More vivid is the experience of specific companies, three of which may be recounted briefly:

General Motors Corporation. As one of the world's largest and most successful business companies, it is not easy to picture that during its early stages, General Motors experienced the common and familiar difficulties of a new enterprise. It was chartered as the General Motors Company in 1908 in the state of New Jersey and, by the end of 1909, "had acquired or substantially controlled more than twenty automobile or accessory companies." Yet a year later, in 1910, it was on the brink of receivership, having "swallowed so many companies in its first two years that acute indigestion followed as a matter of course."[12] Later, in 1916, the present General Motors Corporation was chartered in the state of Delaware by exchanging five new shares of common stock for each share of old stock. The magnitude of its success may be seen by noting that, if adjustments are made for stock dividends and splits, each share of the original common stock is currently worth about $5,500 per share.[13]

Kaiser Motors Corporation. Organized in 1945 as the Kaiser-Frazer Corporation to purchase the assets of the Graham-Paige Motors Corpration, this company experienced considerable difficulty in getting under way. Despite the attendant general economic prosperity, it failed to become an important factor in the automobile market; during the first ten years of its operation, it succeeded in making a profit in only two years. The loss of $35,000,000 in 1954 was the largest in any single period, and its assets at the close of the year amounted to $81,545,281. Sales during the year were $212,375,291 (see p. 194 for later developments relating to this corporation).

Tucker Corporation. While the Tucker Corporation achieved considerable prominence during its short life, its name is no longer commonly known, because of its failure. Organized in 1946, it quickly ran into production and financial difficulties. Actually, no automobiles were ever sold to the public; and the investors in its stock were completely wiped out. In the fall of 1950, its total assets, with a book value of approximately $20,000,000, were sold at public auction for $464,135.

THE PERSONAL ELEMENT IN PROMOTION

It is a familiar observation that institutions are in many respects the lengthened shadows of the individuals who are basically responsible for

[12] Arthur Pound, *The Turning Wheel—The Story of General Motors through Twenty-five Years, 1908–33* (Garden City, N.Y.: Doubleday, Doran & Co., Inc., 1934), p. 121.

[13] The original stockholders of the predecessor General Motors Company, organized in 1908, received five shares of the present corporation for each one of the old; each such old share would therefore have a current worth of roughly $27,500. The total assets at the end of 1959 amounted to $7,246,408,027, and the net sales for the year were $11,233,057,000.

their operations. Although there is variability in the reflection of this feature, it applies to large and small organizations alike. Many of our large business enterprises still bear the names of their founders, and many more reveal the force of their imprint. The element of personal influence is particularly significant in the promotion of new enterprise. Combining imagination and creative energy, promoters provide the aggressiveness that is necessary to overcome the many obstacles which stand in the way of getting a new business started. Many promoters possess only the abilities to start a project and lack the patience and administrative capacity to meet the less spectacular tasks of settled operation. As a result, the promoter may get a business started, only to be forced out or lose control at a later date.

To cite a concrete example of these points, brief reference may be made to the General Motors Corporation. In large measure, it initially developed out of the creative thinking of a single individual—William C. Durant. Connected with the Buick Motor Company at the time, he visualized a consolidation or single control of various automobile and related accessory companies. Describing Durant's activities, one writer said:

> We can picture Mr. Durant at this time as a man desperately hurried, spurred by ambition and responsibility to feats of almost superhuman endurance, driving at breakneck speed over wretched roads between his two plants, holding conferences, making quick decisions, seeking out and encouraging new dealers, scouring the country for supplies and building plants, subduing raw land to industrial and residential uses and feverishly seeking new capital. This spare, small man seemed to draw upon irresistible sources of energy. He worked more hours than any of his employees, did with little sleep, yet came to his labors fresh and smiling every morning. There was a gaiety and resilience in him which overcame all obstacles. . . . His associates referred to him as "the Man."[14]

Although the lure of prospective profits acts as an important incentive, it is likely that ambition and the desire to be creative also serve to foster promotion. Again speaking of William C. Durant, it has been said that "there are innumerable evidences that he cared little for money for its own sake. His own tastes were simple, he had no time to spend money."[15] At the same time, there can be little escape from the realization that without profits and adequate financing, new, as well as existing, enterprises must fail. The element of finance is particularly a key at the time of initial development when it is impossible to have past successes carry for a time the burdens of later unsuccessful operation.

THE FINANCIAL ELEMENT IN PROMOTION

The sufficiency of funds or capital is always vital to business operation, but its need is all the more striking during the period of promoting and

[14] Pound, *op. cit.*, pp. 83–84.

[15] *Ibid.*, p. 84.

organizing a new enterprise. Even a sound idea backed by a capable individual can fail for want of the waiting power which capital provides. As funds are quickly invested in new plants and used for current outlays to cover various expenses, there is an inevitable lag in the flow of income and the realization of cash receipts. Financing, or capital supply, makes it possible to bridge this gap; without it, the project hangs in the balance. Again, the three examples of automobile companies may be cited to show the workings of the financial element:

General Motors Corporation. As indicated earlier, General Motors encountered financial difficulties within two years of its creation. To solve its needs, there was a desperate search for new funds. There was little opportunity to choose the cheapest or most desirable form of financing. As a result, General Motors sold 6 per cent notes or bonds with a face value of $15,000,000 at 85, thereby realizing in new cash the sum of $12,750,000. As security, a blanket mortgage was placed on all its property in Michigan—a special corporation being created for this purpose. In addition, "as part consideration for the loan, $4,169,200 in General Motors Preferred stock and $2,000,000 worth of Common, both at par, were delivered to the bankers."[16]

Another requirement for the loan was a change in management. After exhausting all efforts to raise funds with his continuance in office, Mr. Durant stepped out in order to save the company. The incident is described by one writer in the following way: "In the East he found that he could save the company if he stepped out. J. & W. Seligman & Company of New York and Lee, Higginson & Company of Boston, were interested on that basis, not otherwise. The money centers of the East were conservative; Mr. James J. Storrow of Lee, Higginson, who arranged the rescue represented a school of financial thought which could not approve the dashing methods and hairbreadth adventures which characterized General Motors in its infancy. With Mr. Albert Strauss of Seligman's he decided, further, that the situation had gone so far that not only a change of management but also a trusteeship was required. The terms were hard, but in no other way could a receivership be avoided, so pressing was the need for funds. Mr. Durant swallowed his pride and stepped down."[17]

Kaiser Motors Corporation. The case of Kaiser Motors Corporation is still fairly recent, but it reflects the familiar pattern of guiding individual influence and the key importance of sufficient capital. However, in this instance, there may be seen the enlarged scope of governmental activity which has characterized trends in our economy during the last three decades. At one time, the indebtedness of the Kaiser Motors Corporation to the government amounted to some $75,000,000, and, at the close of 1954, it was about $15,000,000. Were it not for this financial accommodation, it is doubtful whether the company would have survived, its difficulties being sharply brought into focus by its cumulative earned deficit of $113,386,963 as of December 31, 1954. Not too long thereafter, the operations were absorbed as part of a plan to centralize and co-ordinate the major Kaiser enterprises; passenger cars have not been produced for a number of years, but the familiar "Jeep" is a product of a controlled subsidiary, Willys Motors, Inc. The operations of the latter are not reported in sufficient detail to permit specific analysis of its financial record.

Tucker Corporation. As indicated previously, this company was unable

[16] *Ibid.*, p. 128.

[17] *Ibid.*, pp. 127–28.

to carry its initial development into successful operation. Within less than two years after its incorporation, its operating deficit amounted to $5,651,209.[18] In this instance, all funds were obtained privately (mostly from the sale of stock and dealer franchises); however, the company did lease its plant from the government with an option to purchase. Whether or not, in view of its early performance, additional capital would have saved the corporation from failure is debatable.

A CLOSER LOOK

With the foregoing general observations in the background, we may now take a closer look at the unfolding of a relatively new enterprise. It is one of the many firms that have emerged in the electronics field, and its success has been quite notable. Reference is made to Litton Industries, Inc., which was chartered in Delaware in November, 1953.[19]

Nature of Business. In the words of *Moody's Industrial Manual,* this company (including its subsidiaries) "designs and manufactures electronic components and systems, also kylstrons and servo systems, including computers, magnetrons, missile guidance equipment, aircraft guidance and fire controls, portable X-ray machines and other atomic, navigational, communication and instrumentation devices." The difficulties of comprehending the technical functioning of these various items are readily apparent, but, needless to say, such cannot be true of those directing the operations. Granted that technicians will provide the "know how" for the workings of the various devices, business management must also have sufficient appreciation of their functions and uses in order to conduct orderly administration and to attract the requisite capital.

Expansion of the Business. The acceleration of Litton Industries from small beginnings to recognized business stature may be quickly seen in the trends in assets and sales. As of July 31, 1954, assets amounted to $4,200,176, and increased to $119,004,373 as of July 31, 1960. Net sales for the fiscal year ended July 31, 1956, were $14,800,000, as compared with $185,000,000 for the period ended July 31, 1960. The rapidity and extent of the expansion are self-evident, but it should be observed that a large part of it was accomplished by the acquisition of control of other existing companies. Already in its short span of life, Litton has acquired some 33 companies, either by outright merger or by ownership of the stock of those which continue to operate as subsidiaries. Such growth necessarily gave rise to means of accompanying financial accommodation.

Highlights of Financing. The financing of the activities of Litton Industries has its own dramatic, and possibly singular, qualities or features. For example, up to this time, practically all the financial arrangements have been on a private basis, rather than by means of public offerings.

[18] *Moody's Manual of Industrials, 1949,* pp. 1904–5.

[19] Originally it was entitled the Electro Dynamics Corporation and adopted its present name on August 16, 1954.

Under these circumstances, there is less availability of the facts relating to the terms and conditions applicable to the financing, but a review of the reporting by *Moody's Industrial Manuals* does enable us to set forth the highlights of the record. Such features as the following may be observed:

Notes Payable. A considerable amount of money has been obtained from commercial banks, usually in the form of term loans. Such notes appeared for the first time in the July 31, 1955 statement, when they amounted to $648,122 and constituted the third largest single source of funds. As of July 31, 1960, notes payable aggregated $18,266,673 and were exceeded as a source of funds only by earned surplus as will be noted more fully.

Subordinated Debenture Issues. The first reported issue of this type was the subordinated income debenture 5's, due in 1959; as of July 31, 1954, they amounted to $1,430,000, and then remained at a constant figure of $230,000 for some four or five years until their retirement. Probably taking advantage of the popularity of the convertibility feature during recent years, all ensuing debenture issues included this characteristic, as may be seen in the following:

Bond Description	Date of Bonds	Authorized Amount	Outstanding July 31, 1960	Terms of Conversion*
5's, due in 1965.......	Sept. 1, 1955	$1,500,000	$ 662,000	$ 6.58 per share
4¾'s, due in 1974.....	June 1, 1959	4,700,000	4,700,000	65.00 per share
5¼'s, due in 1974.....	Dec. 1, 1959	6,000,000	6,000,000	80.00 per share

* All issues are fully protected against dilution except in the case of the 5¼ per cent issue, there is no adjustment for stock issued by the exercise of options or as a result of the conversion of the 5 per cent preferred stock and the 5 per cent debentures.

The appeal of the conversion feature may be seen in the range of the market price of the common stock (adjusted for a 2-for-1 split and a 2½ per cent stock dividend in 1959) from a low of 7 in 1956 to a high of 96 up to July 31, 1960.

Preferred Stock. This stock bears 5 per cent cumulative dividends and is convertible on the basis of 100 shares of common for each share of preferred stock. Probably as a result of conversions, the stock was reduced in amount from $270,000 as of July 31, 1954 to $79,950 as of July 31, 1957, but, a year later, some $2,774,700 was outstanding. The increase undoubtedly arose out of Litton's acquisition of control of the Monroe Calculating Machine Company pursuant to a plan which offered for each share of common of the latter, stock of the former as follows: 1½ shares of common, or ½ share of preferred, or a combination of the two. As of July 31, 1960, the outstanding preferred stock amounted to $2,846,800.

Common Stock and Surplus. Partly because of the low par value, the amount of common stock is comparatively small—increasing from $52,500 as of July 31, 1954, to $4,158,602 as of July 31, 1960. Paid-in surplus as of the latter date amounted to $10,142,566 as compared with $2,522,614 on July 31, 1955 (the increase arose mainly out of the sale of common stock at a price in excess of its par value of $0.10 to December, 1959, and $1.00 thereafter; also, additions were realized by the issuance of common stock in exchange for convertible securities). The earned surplus naturally reflects the retained earnings of the company's direct operations as well as the accumulations of subsidiaries ac-

quired under the expansion program. The earned surplus amounted to only \$654,778 as of July 31, 1955, following which it increased sharply in keeping with the marked success of the operations; as of July 31, 1960, the earned surplus amounted to \$21,377,614. From these figures, it is clear that most of the net worth is in the form of the two surplus accounts.

SOME OBSERVATIONS

The successful launching of a new business venture is usually contingent upon three vital factors: capacity and character of sponsorship, the state of business conditions, and the availability of funds.

Sponsorship. Strong sponsorship not only provides the inner force to overcome many obstacles, but, in addition, it attracts external recognition and support. The latter reference is made not only to the general public but also to "private connections" of power and influence. Particularly may investment bankers play a part in procuring timely financing and in making arrangements for the acquisition of other companies.

Business Conditions. While strong sponsorship may be of sufficient strength to overcome adverse business conditions, we know that proper timing may be a crucial element in determining the success of any endeavor. For example, the generally high level of business during the decade of the fifties clearly favored the successful launching of new businesses—and particularly where their activities were related to the expanding needs of electronic and technological development.

Availability of Funds. The availability of funds is an obvious requisite to bridge the crucial step from a new to a going concern, and is obviously dependent upon the background influence of the capital market. During much of the fifties, the supply of capital was such as to facilitate private financing in many instances—such as the case of the Litton Industries described before. Others must resort to public offerings where the terms of financing may be more costly and rigorous. For example, in early 1960, the New Precision Transformer Corporation issued 6½ per cent convertible debentures, due in 1970, and the underwriters were allowed a spread of 12 points; and the Baltimore Paint and Chemical Corporation sold 5½ per cent debentures (with warrants to buy stock), due in 1975, with the underwriters having the benefit of a spread of 10 points.

GENERAL COMMENT

Generally speaking, it may be said that new enterprise often finds it necessary to improvise its financing and to take risks that may be avoided by established companies. Almost of necessity many new companies give primary consideration to short-term benefits in the hope that successful operation will permit adjustment at a later date to more normal and economical financing. In the next two chapters, attention will be given to the

problems which are inherent in a financial plan, otherwise known as "capitalization."

QUESTIONS AND PROBLEMS

1. Why does the new corporation reflect *social* as well as *business* significance?
2. Discuss the relationship between promotion and the state of national development; between promotion and the type of business; and between promotion and social progress.
3. What is meant by the statement that the role of finance is "the nurturing and carrying of business enterprise"?
4. "In the development of new enterprise, risk is the cardinal factor to be faced by the promoter." Discuss the following: (*a*) Who should bear the risks of promotion? (*b*) What safeguards can be provided to minimize the risks? (*c*) Should government allow special incentives to encourage the assumption of the risks?
5. Why is it possible for government-owned and government-controlled organizations to operate without a profit? Under what circumstances might this be desirable? Undesirable?
6. Show how government regulation would be likely to affect the development of television more than of nylon. Also consider the relative effects on financial policy and business management.
7. In a review of the electronics industry (see Edgar, George, "Expanding Frontiers of Science and the World of Electronics," *Commercial and Financial Chronicle*, Vol. 191, No. 5944 [April 1, 1960], pp. 1, 30), the author reported that the number of manufacturers of television sets had declined from 90 in 1953 to 29 in 1960. (*a*) Discuss the reasons for this decline. (*b*) Consider the problems of starting a new company in a relatively new field of business, such as electronics, with those in an established area of operation, such as automobiles.
8. What is meant by the statement that "losses may be legitimate and necessary"?
9. Discuss the nature of the subsidy provided by investors and speculators who lose funds in the development of a new company. What are the alternatives?
10. Evaluate the comment that the response to chance is likely to be out of proportion to its own limited worth.
11. Do you think that there should be regulation of circulars covering the sale of securities of small companies?
12. Discuss the importance of the ownership equity as a force in the promotion and development of business.
13. To what extent should government spur business development by the use of subsidies and tax concessions?
14. What is your opinion of the merits of granting options to buy stock at a favored price in a new company to (*a*) management personnel and (*b*) bankers who underwrite the sale of securities?
15. Discuss the nature and importance of "private connections" as mentioned on page 197.
16. Evaluate the record and financial policies of Litton Industries, Inc.
17. Evaluate the observation that new companies may often find it necessary

to "improvise" their financing (see page 197), and consider the policy of giving "primary consideration to short-term benefits."

REFERENCES

BOGEN, J. I. (ed.). "Promotion," *Financial Handbook*, pp. 349–66. New York: The Ronald Press Co., 1957.

BRADLEY, JOSEPH F. *Fundamentals of Corporation Finance*, chap. i. New York: Rinehart & Co., Inc., 1959.

BUCHANAN, N. S. *The Economics of Corporate Enterprise*, chap. vi. New York: Henry Holt & Co., Inc., 1940.

DEWING, A. S. *Corporate Promotions and Reorganizations*. Cambridge: Harvard University Press, 1914.

GERSTENBERG, CHARLES W. *Financial Organization and Management of Business*, chap. x. Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1959.

POUND, ARTHUR. *The Turning Wheel—The Story of General Motors through Twenty-five Years, 1908–33*. Garden City, N.Y.: Doubleday, Doran & Co., Inc., 1934.

PRATHER, CHARLES L. *Financing Business Firms*, rev. ed., chap. 24. Homewood, Illinois: Richard D. Irwin, Inc., 1961.

RISCHER, GUNTER. "Research and Development Costs and Stock Prices," *Commercial and Financial Chronicle*, Vol. 193, No. 6058 (May 25, 1961), pp. 12–13.

SILBERMAN, RICHARD T. "Helpful Equity Financing for Electronics Companies," *Commercial and Financial Chronicle*, Vol. 191, No. 5946 (April 28, 1960), pp. 18–19.

Stevens on Corporations, chap. vi. St. Paul: West Publishing Co., 1936.

TAITEL, M. *Profits, Productive Activities and New Investment* (Temporary National Economic Committee, Monograph No. 12). Washington, D.C.: U.S. Government Printing Office, 1941.

TAUSSIG, F. W., and JOSLYN, C. S. *American Business Leaders*. New York: Macmillan Co., 1932.

WATKINS, M. W. "Promotion," *Encyclopaedia of the Social Sciences*, Vol. XII, pp. 518–21.

Chapter 12 ►

CAPITALIZATION AND FINANCIAL PLANNING

THE LONG-TERM financial framework of a corporation, commonly known as its capitalization, constitutes in many ways the foundation of successful operation. Even products or services of recognized merit may founder on the shoals of either inadequate or poorly timed financial accommodation. Unfortunately, the term "capitalization" has a variety of definitions, but, even so, we may add to our appreciation of its nature by noting the differences of concept. One authority defines "capitalization" as "the sum of the par value of the stocks and bonds outstanding"[1] and includes no-par stock only by reporting the number of shares outstanding; another says, "The term 'capitalization,' or the valuation of the capital, includes the capital stock and debt";[2] and still another states that it is "a word ordinarily used to refer to the sum of the outstanding stocks and funded obligations . . . which . . . may represent wholly fictitious values."[3]

The ordinary meaning of capitalization is the computation, appraisal, or estimation of present value. To illustrate, the valuation of an income is computed by dividing the amount by a given rate of interest, allowance being made for the duration or life of the income. Thus, the capitalization of an annuity of $10,000 per year at 4 per cent would be $250,000. If the rate of interest used to compute the value were 5 per cent, the capitalization would be $200,000. The capitalized result ($200,000 in the latter case) constitutes an asset in favor of the owner and arises out of the existence of the annual income. In many respects, this valuation concept underlies the definitions of capitalization previously cited, since the emphasis is placed upon the *amount* of capital. The same thought is

---

[1] H. G. Guthmann and H. E. Dougall, *Corporate Financial Policy* (New York: Prentice-Hall, Inc., 1948), p. 74.

[2] A. S. Dewing, *Financial Policy of Corporations* (New York: The Ronald Press Co., 1926), p. 6.

[3] E. E. Lincoln, *Applied Business Finance* (New York: A. W. Shaw Co., 1923), p. 86.

generally present in legal usage of the term. For example, if provision is made for common stock in the amount of $100,000 and preferred stock of $50,000, then the capitalization is said to be $150,000.

OUR USE OF THE TERM "CAPITALIZATION"

Recognizing the confusion in the use of the term "capitalization," one writer has concluded that various conditions "defy accurate or even useful definition of capital and capitalization."[4] However, the term is frequently used and especially on the "financial street." For this reason, it should be a part of the reader's vocabulary; ~~and we shall give~~ our version of its connotation in everyday financial affairs. In brief, the term "capitalization" is generally used in the sense of meaning the long-term financial or capital structure; and it embraces the composition or character of the structure as well as the amount. Like so many words, "capitalization" has taken on added meaning by use. Originally, it was undoubtedly used primarily in the sense of valuation and amount; but qualitative connotation now usually accompanies the quantitative expression. Indeed, it means little to say that a company has a capitalization of $10,000,000 without knowing the relative amounts of bonds and stocks. The plan or pattern of financing must also be known in order to get a meaningful concept of the picture. Because of these conditions, we shall differ from other writers who set forth a limited definition or avoid it and shall use the term "capitalization" as being synonymous with capital structure or financial plan.

FINANCIAL PLANNING

What stands out so plainly in the newly organized corporation is also ever present beneath the surface in existing companies: Financial planning is the key to successful business operation. The picture may be quickly brought into focus by reference to the familiar accounting balance sheet. On the one side are the assets, which are usually classified according to the degree of liquidity; on the other side are the liabilities and the ownership equities. The balance sheet is much more than an accounting statement; it also reflects financial stewardship, which requires that the assets be equal to the obligations. There is both symbolism and realism in the *balance* that must be maintained between the assets, on the one hand, and the liabilities and ownership equities, on the other hand. Any inequality would mean an impairment of capital; and, if the condition persisted, insolvency would be the final result.

Because the total assets must be offset by an equal aggregate amount of liabilities and proprietorship capital, it follows that the composition of

[4] H. E. Hoagland, *Corporation Finance* (New York: McGraw-Hill Book Co., 1947), p. 348.

the latter two may prove to be the cause of the life or death of the corporation. Excessive short-term debt may be the cause of serious embarrassment if the amount and liquidity of the assets are not sufficient to meet the obligations. Exacting requirements for the liquidation of long-term debt may prove to be burdensome in the light of later unforeseen developments. Hence, for all practical purposes, the sources of capital are often the ruling forces in matters of management policy. The following three questions suggest the possible relations between the financing side and the operating structure, which is represented by the assets: (1) Should the financial plan be set up in terms of the life expectancy of the assets? (2) Is it intended that the asset accounts be constantly administered to meet financial requirements? (3) Does the economic process compel adjustments on both sides?

It is difficult, if not impossible, to give categorical answers to these questions. Nor may the answers be determined by any empirical observations of day-to-day operations. Prevailing business practice represents an aggregation of varying policies based either upon sound, long-range planning or upon temporary and pressing financial expediency. It would be difficult to derive from this practice any conclusive answer to the questions or to earmark the exact part played by finance in any given situation. However, some light may be thrown on the problem by observing the nature of the investment of the assets and the resulting pressures of financial expediency.

ARRANGING THE FINANCIAL PATTERN

In an abstract sense, it would seem that financial policy should arrange the sources of capital so as to accommodate at all times the carrying of the assets. However, there are many practical difficulties which retard such synchronization of financial accommodation with operating or asset needs. This may be illustrated by assuming the organization of a company whose assets and equities at the outset are as follows:

BALANCE SHEET OF THE MAKUP CORPORATION

Beginning of Operations

Assets		*Sources of Capital*	
Cash	$100,000	Definite promises to pay	$ 25,000
		Ownership account	75,000
	$100,000		$100,000

In this initial stage of the life of the corporation, a marked degree of flexibility is evidenced. To put the company into operation, it is necessary to utilize the cash for purposes of constructing the plant, purchasing raw materials, paying wages, and for various other operations. While the changes reflect a conversion rather than a dissipation of values, they do increase the degree of rigidity in the asset accounts. To show the possible

results of these operations, the following financial condition may be assumed one year later:

BALANCE SHEET OF THE MAKUP CORPORATION

ONE YEAR LATER

Assets		*Sources of Capital*	
Cash	$ 10,000	Definite promises to pay	$ 25,000
Accounts receivable	10,000	Ownership account	80,000
Inventories	15,000		
Plant	70,000		
	$105,000		$105,000

An inspection of the new statement reveals a decided change in the distribution of the assets. The conversion of cash into income-producing assets has made possible the transition to an operating and earning basis; but, simultaneously, the immediate capacity to discharge the various equity and liability obligations has been weakened. If the liability maturities and other capital demands are properly related to the asset accounts and are capable of some adjustment, the life of the business will be allowed to function in a normal way. However, serious difficulties may develop if too great a degree of rigidity is present in the financial structure.

The extreme possibility that the "definite promises to pay" had a maturity of one year may be assumed with reference to the new balance sheet. While the current assets total more than the promises to pay, any delay in the regular conversion of current assets, represented in the form of accounts receivable and inventories, into cash might result in forced liquidation or reorganization, with the attendant sacrifice of values. Any refusal of the creditors to renew the obligation would force the company to liquidate its assets or to make arrangements for financing elsewhere. The latter alternative might be difficult and would be subject to all the variations brought on by money-market and general business conditions. Tight money might be the cause of upsetting an operating condition which would have proved entirely sound had the company experienced a greater period of development or had it been able to refinance on satisfactory terms. For example, the events following 1929 placed many corporations in a difficult position for meeting maturing obligations or for arranging new financing. As a result, a greater emphasis has been placed upon liquidity and flexibility; and many corporations now carry cash accounts much larger than are necessary to meet the requirements of normal business.

RELATIONSHIP BETWEEN OPERATING AND FINANCIAL ELEMENTS

The foregoing review serves to emphasize the vital relationship between the asset area and the financial area of the corporation. In turn, it points to the virtual impossibility of attaining the ideal wherein technical

operation may be regarded as primary and controlling. Instead, the important element of control is usually found within the secondary process of finance. This accounts for the fact that much of the life history of business is found in the evolution of the financial program. Relatively rigid composition of the financial structure may be the cause of much irritation and may unduly limit the physical operations. Under such circumstances, the plan of financing can easily become a burden rather than a tool.

Railroads are in many ways an outstanding illustration of many of these points. Over the years the appearance of new sources of competition and the erratic effects of general business conditions have taken their toll in undermining the expected stability of this public utility. Responding to the pressures of reorganization, and likely to the expediencies of the capital market, railroad management has created a financial structure that in many instances is top-heavy with debt. All too often fixed charges are inordinately high in relation to operating income, and pressing maturities restrict the freedom of action in arranging for new financing. In short, there is a lack of harmony between financial arrangements and the supporting operating structure.

INFLUENCE OF SOURCE OF CAPITAL

To afford protection against the stresses and strains of ever-changing business and social conditions, many believe the financing of the future must include more ownership capital, sometimes termed "venture" capital. The simplicity of this plan is attractive, but its practicality is uncertain. Ownership capital as represented by stock means the substitution of optional dividend charges for the fixed charges represented by interest on bonds. However, it is doubtful if optional dividend charges can furnish much in the way of permanent corrective relief. In the long run, return on the investment must be satisfactory, whether it is optional or otherwise, if new capital is to be attracted when needed. Financial convenience is not the same as economic justification; the former can effect temporary relief, but it is not sufficient to make the industry self-supporting. This again reflects the primary character of the business process as distinct from the secondary nature of the financial factor. Moreover, there is always the tendency for expediency to work at cross-purposes with basic economic objectives. This is especially true in the financial area where the appeal of the security issues in the market is often given more emphasis than their position in the plan of the business. As a result, bonds with maturities entirely unrelated to the asset structure may be issued instead of stock, which would impose less rigid demands upon management.

The ultimate outcome of pursuing a policy of expediency in financing may be to place certain portions of the financial structure of a corporation

in a strategic position in times of distress. Investors naturally seek to preserve their own investment; and the favored security holders may be expected to resist any major adjustment or overhauling of the financial structure, no matter how necessary it might be for successful future operations. In many instances, this causes one financial error to be pyramided on top of another and makes an unsatisfactory situation worse. Operating management is then loaded with an overhead not justified in the light of the earning power of the particular enterprise.

The source of capital, because of its strategic position, exercises tremendous influence upon the success of an enterprise; but it is only a part of the larger criterion of sound business operations. In the last analysis, this is determined by the self-supporting or self-sustaining character of any particular enterprise. The real question is whether its output is sufficient to replace or retire the investment as well as to cover the attendant current demands incident to operation. The latter consist of the usual operating expenses plus a fair return to those providing the capital. The financial plan must recognize and facilitate these ultimate and more controlling demands of business. Flexibility must be maintained at all times, and the need for financial readjustments must be faced realistically.

The most effective means of providing flexibility is found in recognizing the importance of the ownership equities. Despite the absenteeism that exists because of the number and scattered location of stockholders, the ownership account constitutes the anchor of a financial plan. In the same way in which the equity of an individual in his home gives resilience to protect the security of the mortgage, the ownership, or equity, in a corporation provides leeway to meet the "ups and downs" of business activity. The equity in a corporation consists of the stock, reserves, and surplus; and these may be adjusted in varying degrees to meet adversities. At the same time, it is necessary that the stockholders receive the benefit of gains made by the corporation in order to have the morale to meet less favorable periods.

INFLUENCE OF TRADITION AND THE SECURITIES MARKET

The financing of business is also affected by the prevailing financial styles and the accumulated financing pattern. There is difficulty in pursuing an individualistic course of action because of the familiar pressures of prevailing environment. As a result, there is almost an inevitability in catering to the mood of the financial market, since deviation may require a costly course of special justification. In many respects, the market is "king" and rules with an iron hand.

This reconciliation of the business process with financial patterns is to a great extent taken as a matter of course. In practice, it is assumed; only in the background of principle is it possible to take into account the deeper question of organic relationship. It is easy to prove in the realm of

logic the principle that business is primary and that finance is secondary, but this does not assure its application in day-to-day practice. By analogy, it may be noted that economists have long since proved the merit of free trade; but the various forces of expediency have brought about wide adoption of the protective tariff system. Equally so, finance and business relationships are subject to the appeal of present gain as against a sounder, long-term policy offering the chance of profit only in the future.

The dominating influence of the market raises the pointed query as to what can be done about it. Long-term planning of financing, for instance, may be an interesting item for the agendum; but unless it is accepted by the market, it is void of meaning. Actually, the answer is likely one of compromise. A balancing of short-term gains must be made against the longer-term implication of any given program. These alternatives only accentuate the responsibilities of management; but management is human, and human beings think too often in terms of the short run.

ANALYSIS OF AMOUNT OF CAPITALIZATION

In many respects, the essence of finance is found in the provision of funds in sufficient amount and in proper time to meet the needs of a corporation. Availability of cash may be a matter of life or death. Sufficiency of cash can keep an unsuccessful firm going despite losses; and, conversely, insufficiency of cash can bring failure in the face of actual or prospective earnings. Illustrative of the former is the Advance-Rumely Company, which suffered an annual deficit without exception for the period from 1922 to 1929, inclusive; and the same condition appeared on a wide scale during the long depression of the thirties. A dramatic example of the latter condition—earnings without sufficiency of cash—is found in the early history of the General Motors Corporation. Its net sales "for the first year of operations, ending October 1, 1909, were $29,029,875, and net income available for dividends, $9,114,498";[5] yet, as reported in the previous chapter, it was saved from receivership only by capitulating to the bankers in order to get funds. Its expansion in fixed plant had used up cash so that current obligations and expenses could not be met. The well-known Westinghouse Electric Corporation failed under similar conditions in 1907 after several consecutive years of earnings. Such cases clearly reflect an important function of capitalization, viz., to provide a sufficient amount of funds to meet the proper needs of a corporation.

Since sheer sufficiency of funds may be the difference between failure and success, it is not at all unusual to violate commonly accepted principles of sound financing purely for the purpose of getting money. A new company, or even an established enterprise, may be in a better long-term

[5] Arthur Pound, *The Turning Wheel—The Story of General Motors through Twenty-five Years, 1908-33* (Garden City, N.Y.: Doubleday, Doran & Co., Inc., 1934), p. 123.

position without the rigorous burden of fixed interest on bonds; but it may, nonetheless, be forced to issue bonds in order to get funds at all. To illustrate, many well-known corporations which today have no outstanding bonds when they can afford to carry them, were compelled to issue such obligations in their early history in the face of uncertain performance because they had little alternative. A case in point is the General Motors Corporation which, as mentioned earlier, issued as a matter of necessity a first-mortgage bond, secured by all its property in the state of Michigan, within two years of its creation; yet, since that early period, it has seldom resorted to a funded debt as a source of funds, even though its bonds would have been in great demand.[6] Possibly more than we like to admit, expediency seems to invite improvisation of financial rules.

Since it would be easy to conclude that the safest course of action would be found in raising funds to the point of excess, it should be stressed that numerous restraints prevent any such simple solution. First, securities must be sold to investors who demand proof that their funds will be reasonably safe and want evidence of the prospect of an income return. Second, excess funds may result in onerous, recurring interest charges which must be met; or in expected dividends which, if not paid, may injure the credit standing of the corporation. Third, the amount of funds which can be raised may not be so much a matter of calculation by management as it is a determination of whether the investment market will permit the successful flotation of the securities. Generally speaking, the key to market response is found in the risk appraisal of securities; and companies that desperately need funds usually have difficulty in raising them.

RELATIONSHIP BETWEEN VALUE AND CAPITALIZATION

As stated previously, we are using the term "capitalization" to mean the securities structure or the plan of long-term financing. At the same time, we may note that it has inevitable value connotation. Assuming that full consideration is received for the securities issued, it would follow that the latter should be a convenient and ready measurement of the value of an enterprise. However, these conditions are too static to permit other than momentary measurement of value. Both this, and the problems relating to the amount of capitalization, may be seen to advantage as they relate respectively to new enterprises and to established companies.

CAPITALIZATION OF THE NEW ENTERPRISE

In launching a new enterprise, reasonable provision must be made for future as well as for current needs. Hence, there arises the danger of

[6] Unsecured debenture bonds of $300,000,000 were issued in 1954, bearing an interest rate of 3¼ per cent, and maturing in 1979.

either raising excessive or insufficient capital. Both errors may result in unfortunate consequences. Under the former condition, the funds cannot be fully invested in the anticipated area of operation; as a result, investors fail to receive a fair rate of return and management may be prone to make hasty, unwise investments. Conversely, insufficiency of funds curtails the opportunity for development and easily leads to unsound borrowing and its attendant hazards.

A new enterprise operates at great disadvantage in the raising of capital because there is no gauge of the risk entailed. Lacking the seasoning of an established company, promoters of a new company frequently become beggars instead of choosers of capital. As a result, they may be compelled to pay high rates; and their sources may be determined by expediency more than by judgment. The significance of capitalization as a measure of value is also weakened once the project is put into operation because the early stages are in many respects a discounting of future possibilities.

To determine the amount of capitalization, two theories have been propounded: (1) the historical cost theory, in which the capitalization is regarded as the equivalent of the cost actually incurred in setting up the corporation; and (2) the earnings theory, in which the probable earnings are forecast and capitalized at a representative rate of return.

The Cost Theory. Under the cost theory, the amount of capitalization is based upon the original, out-of-pocket investment in plant, equipment, etc. Obviously, the use of initial cost facilitates the calculation of the amount of capital to be raised; but it may prove deficient as a formula for taking care of future needs. Under this plan, greater stress is placed upon current outlays than upon the requirements necessary to accommodate the transition to a going-concern basis. As a means of meeting the demands of getting started, it is often desirable, when the investment market permits, to provide for additional funds to cover various contingencies.

Upon first thought, the cost principle may appear to give assurance that the capitalization would at least be representative of the value of the enterprise. However, as indicated previously, this correlation would exist only momentarily. Original cost is static in character and would in no way reflect future changes. Not only is it possible for the capital equipment to become obsolete, but, in addition, true worth is also dependent primarily upon earnings.

The Earnings Theory. Earnings as a test or measurement of the amount of capitalization have significance in their own right and also as a double check on the costs of launching a new enterprise. Of course, the earnings are necessarily estimated; but, even so, they must be projected because they are the key to success. On the one hand, the commitment of new capital to a new venture is warranted only if its recovery, combined with a fair return, appears to be feasible; on the other hand, without sufficient earnings, it is obviously not possible to pay interest and

dividends. In short, earnings and capital investment complement each other and are mutually dependent.

Under conditions of active competition, the two bases should be in approximate agreement. If competition is functioning, the profit levels of a business should be no higher than an amount that would be regarded as a favorable return on the investment. Abnormally high profits in a line of enterprise would tend to encourage added investments in that business, which would in time reduce the profit yields to the competitive standard. On the other hand, if the profit yield failed to support a value on an earnings basis which was equal to cost, it would be expected that no new investment would be made in the field unless the cost of establishing a new enterprise could be reduced to harmonize with probable earnings.

CAPITALIZATION OF THE ESTABLISHED COMPANY

The amount of the capitalization of an established concern is much more easily determined than that of a new company. The past record of operations provides a basis of experience upon which to proceed, and future needs may be more nearly computed than when starting with an untried and unknown venture. As a general rule, it is also desirable to allow for a comfortable margin of contingency, particularly if capital-market conditions are such as to raise capital advantageously. Even the best-managed firm may have difficulty in obtaining capital in a very weak market; but, in times of surplus money, capital may be had almost for the asking. Management must be guided accordingly and plan its financial program along these opportunistic lines.

The established corporation also shows in striking manner the deficiencies of capitalization as a measure of value. Here it is possible to apply other objective tests against the capitalized figures, particularly the following: (1) the value of the corporation as expressed in the securities market and (2) the value of the corporation on a capitalized earnings basis.

VALUE AS EXPRESSED IN THE SECURITIES MARKET

Economists have often said that the nearest approach to a perfect market is that of the New York Stock Exchange. This institution provides every facility for a ready expression of demand and supply, and the prices established over a period of time should therefore be representative. Comparing market and book values, we find considerable spread; for example, in the fall of 1953, some 62 per cent of all common stocks listed on the New York Stock Exchange were selling at a price below their book value, with 48 per cent at a price of 20 per cent or more below the book figure.[7]

[7] *The Role of the Saver in America*—remarks by G. Keith Funston, President, New York Stock Exchange, before the Association of Stock Exchange Firms, Hotel Statler, Washington, D.C., February 15, 1954, p. 5.

Specific examples of the disparity between book and market values are shown in Table 14.

The discrepancy existing between book and market values is caused by numerous factors. One reason arises out of accepted accounting policy whereby cost or market, whichever is lower, is used as a basis for evaluating inventories. This may be justified as a means of encouraging conservatism; but it may, under some circumstances, be the source of a wide disparity between the book value and market value of a company. A more important reason for the difference is the failure to record changes in the value of the asset accounts. Under standard accounting practice, fixed assets such as land and buildings are recorded at the cost figure; and no further changes are made except to accrue depreciation

TABLE 14

COMPARISON OF BOOK AND MARKET VALUES OF SELECTED COMPANIES
(000 Omitted)

Company	1940		1950		1959	
	Book Value*	Market Value†	Book Value*	Market Value†	Book Value*	Market Value†
American Sugar Refining Co.	$ 106,678	$ 45,000	$ 114,954	$ 81,788	$ 144,405	$ 119,588
American Tobacco Co.	217,916	438,590	314,399	452,085	515,469	1,361,861
General Motors Corp.	1,103,829	2,252,089	2,414,608	4,640,347	5,521,995	14,994,229
United States Steel Corp.	1,404,796	926,325	2,102,871	1,415,936	3,296,455	5,843,641
United Fruit Co	166,067	213,525	285,405	644,963	356,516	298,022
American Telephone and Telegraph Co. (parent company)	2,379,248	2,989,920	3,872,568	4,391,460	10,674,351	17,661,982
Consolidated Edison Co. of New York	702,038	551,240	713,468	569,900	870,163	1,147,152

* Book value is calculated by totaling the proprietary items—stock outstanding, surplus, and proprietary reserves.

† Market value is determined by multiplying the average of the high and low prices of the shares for 1940, 1950, and 1959, respectively, by the number of shares outstanding. The process is the same for both preferred and common stock.

and to recognize actual transactions. As a result, considerable appreciation in the value of the fixed assets may take place without being a matter of record; and, conversely, there may be failure to recognize obsolescence or other causes of value depletion.

Furthermore, the fundamental nature of book and market values prevents any close correlation of the two figures. Market value is based primarily upon the anticipated future operations of the company, whereas the book value represents past transactions. Generally speaking, this causes market value to be less than the book figure when prospects may be uncertain or if earnings lack the vigor to make the invested capital appear attractive. Oppositely, if the company has built up large and valuable secret reserves, or if the future outlook is bright, the market value may be expected to be considerably above book value.

VALUE AS EXPRESSED BY CAPITALIZED EARNINGS

A comparison of book value with capitalized earnings gives the results shown in Table 15. The computations have been made upon the basis

of a 6 per cent capitalization rate. This rate may appear to be high when judged in the light of interest rate levels in recent years, but it should be satisfactory for comparative purposes. Also, a return of 6 per cent is not generally deemed to be excessive as a return upon common stock. Except for certain instances, it is apparent from Table 15 that the figures of

TABLE 15

COMPARISON OF BOOK AND EARNINGS VALUES OF SELECTED COMPANIES
(000 Omitted)

Company	1940		1950		1959	
	Book Value*	Earnings Value†	Book Value*	Earnings Value†	Book Value*	Earnings Value†
American Sugar Refining Co	$ 106,768	$ 50,400	$ 114,954	$ 135,285	$ 144,405	$ 166,029
American Tobacco Co	217,916	421,850	314,399	650,172	515,469	942,996
General Motors Corp.	1,103,829	3,056,116	2,414,608	7,688,146	5,521,995	14,622,313
United States Steel Corp.	1,404,796	936,133	2,102,871	2,422,402	3,296,455	5,645,756
United Fruit Co.	166,067	217,633	285,405	868,343	356,516	433,688
American Telephone and Telegraph Co. (parent company)	2,379,248	2,826,183	3,872,568	3,568,999	10,674,351	11,400,245
Consolidated Edison Co. of New York	702,038	582,550	713,468	599,870	870,163	905,271

* Book value is calculated by totaling the proprietary items—stock outstanding, surplus, and proprietary reserves.

† The earnings consist of the balance before declaration of dividends and are the average for the five years ended 1940, 1950, and 1959, respectively. These have been capitalized at 6 per cent.

capitalization as represented by book value seldom approximate the capitalized earnings value. In this comparison, as in the former one, the book figures are too static to reflect the changing values which accompany variations in earnings. Although the net results of operations are incorporated into the records, no change is ordinarily made in the initial capitalization as a result of changed earnings conditions.

UNDERCAPITALIZATION AND OVERCAPITALIZATION

Our analysis of the meaning of capitalization would not be complete without further consideration of its dualistic nature. Although the term is used most frequently in its qualitative sense to give expression to the pattern or source of funds, there is also wide usage of its quantitative connotation. The dualism is confusing but, in essence, it reflects the familiar abstract and concrete facets of almost any economic object. To use a simple illustration for purposes of clarification, we may assume that an individual received a piece of property as a gift. The question then arises as to how this property will be represented in his balance sheet. Assuming a fair market value of $100,000, we may consider the alternative of showing the property as having a value of $1 or $200,000, respectively. In case of the former, his capital account on the liability side (or capitalization) would be said to be *undercapitalized* because it understates the actual value of the assets. Conversely, an overstatement of the property value would create a condition that would be designated as *overcapitaliza-*

tion. As may be seen in the ensuing discussion, the term "undercapitalization" either may connote a condition of insufficiency of funds to function properly or it may have reference to the failure of the capital structure to reflect adequate value of the assets; overcapitalization will necessarily reflect the opposite circumstances.

Undercapitalization. In the quantitative sense, undercapitalization exists when insufficient provision is made for funds to operate on the most productive basis. Sometimes, this is brought about by a deliberate desire to start operations on a limited scale and to expand as the opportunity arises. At other times, the supply of capital is restricted because of an inability to obtain it on a reasonable basis from the investment market. In either event, the problem of a shortage of ready funds can arise at a later date unless favorable earnings come to the rescue.

Qualitative undercapitalization is found whenever values are deliberately carried on the books of account in an amount that is less than the value of the assets. Often, to be conservative, management may write down the value of the assets below their fair value for the purpose of creating hidden or secret reserves. Equivalent adjustment of surplus or stock value is then a necessity. Such practice may be motivated by a strong desire to build an ultrasafe financial position; but, at the same time, it does conceal the real facts from investors. Also, it places the corporation at a disadvantage for the computation of excess profits taxes. This form of tax, as described more fully in Chapter 34, is based on the income that exceeds a specified return, which, in turn, is computed as a percentage of the book value of the capitalization.

Overcapitalization. The term "overcapitalization" is used to convey the two converse senses of those just described. Considering it in the sense of a redundancy of capital, it may be observed that this is not a common condition. Generally, it is found in companies with depleting assets, such as oil and mining concerns. To correct the situation, it is customary to declare a capital dividend for the purpose of returning the funds to the investors for other use.

When overcapitalization exists on the basis of deficient offsetting values, the condition is commonly known as "watered stock." Quite frequently, the latter is considered to be any stock which is sold for less than its par value.[8] However, this is not necessarily true in fact. The stock may be matched by equivalent assets in the form of cash and other

---

[8] Generally, stock must be issued for a consideration equal to or in excess of par value; otherwise, shareholder liability attaches. R. S. Stevens, *Handbook on the Law of Private Corporations* (St. Paul: West Publishing Co., 1936), p. 690. (This book will be referred to hereafter as *Stevens on Corporations*.) However, in the absence of provisions of law requiring payment equal to par value, or if authorized under certain conditions by statute, stock may be declared to be fully paid even though sold at less than par value. Needless to say, under no circumstances would fraud be condoned.

consideration realized at the time of sale; and the discount is, of course, offset by the liability of the stockholders for an identical amount which may be collected by the corporation whenever deemed necessary. Nor does it seem reasonable to hold arbitrarily that no-par stock cannot be watered simply because it lacks a nominal or declared value. Actually, the source of the trouble is found in the values placed on the assets realized from the sale of stock—and particularly in the intentions in establishing the values.

According to the standards established by the general corporation laws of all states, stock may be issued only (1) at a uniform price to all subscribers and (2) for value received. The first requirement is applicable only to a given series, which means that later issues may be sold at prices more adaptable to prevailing market conditions. The second requirement is the cause of the greatest trouble. Not only is it difficult to determine a universally acceptable value for fixed tangible property, but complications also result from the evaluation of both current assets and intangible property items and of services.[9] For example, stock may be issued in exchange for patent rights equivalent to the actual costs of developing and obtaining the patent rights. Thus far, the transaction is apparently on a value-received basis; but this by no means guarantees that the patented article will prove profitable. In the event of failure, the stock becomes, in effect, watered.[10]

Watered stock is believed to be created especially when used to recompense the promoter and his cohorts for their services, and undoubtedly this is often true. An equitable valuation of the promoter's services is a perplexing problem. Viewed at the time of promotion, the reward of the promoter may seem to be unduly high; but if the corporation is successful, it may be entirely justified. Any overstatement of the value of these services, however, must of necessity give rise to watered stock.

---

[9] Some courts hold that the property in question must *in fact* be equal to the par of the stock issued in exchange. Under the "true-value" rule, there is the risk that some time in the future it may be held that the property was overvalued. Good faith and judgment have nothing to do with this approach (*Stevens on Corporations*, p. 694; *Meyer* v. *Ruby Trust Min. & Mill. Co.*, 192 Mo. 162, 189; 90 S.W. 821; *See* v. *Heppenheimer*, 69 N.J. 36; 61 A. 843). The majority of American courts hold to a "good-faith" rule. Proof of overvaluation of property is insufficient unless lack of faith can also be established. Valuation by the directors without due consideration of the elements of value, or if based upon factors that are not property or upon self-interest, will constitute violation of good faith as much as the presence of fraud (*Donald* v. *American Smelt. & Ref. Co.*, 62 N.J. Eq. 729. Quoted in *Stevens on Corporations*, p. 697). For a complete analysis of the legal phases of watered stock, see D. L. Dodd, *Stock Watering: The Judicial Valuation of Property for Stock Issue Purposes* (New York: Columbia University Press, 1930), chaps. iii–vii.

[10] While the stock will have become watered in the economic sense due to the dissipation of values, it will not be watered in the legal sense unless it can be shown that the cost value was in excess of any likely value based upon commercial possibilities.

Another condition in which the question of equivalent value may be raised occurs when converting a sole proprietorship or a partnership into a corporation. To make the transition, stock is exchanged for the property of the old enterprise. In turn, the stock may then be sold by the owners (usually through the medium of a banking house) to the public at prices in excess of recognized or previously admitted values. For instance, a corporation was organized in 1915 to take over a business which had existed under a personal form of organization for almost a century. Shares were not offered to the public until many years later, when 182,328 shares were sold at a price of $39.50 per share, giving the original holders of the stock a total of $7,201,956. However, they continued to hold most of the remaining shares outstanding (a total of 400,000 shares were issued) and thereby retained control. The book value per share, as of the date of sale, amounted to approximately $11.32, while, as noted above, the public paid a price of $39.50. Moreover, the total assets reported by the corporation amounted to $5,524,640, or almost $2,000,000 less than the public paid for less than half of the holdings.

Immediately, the question may be raised in the preceding case as to whether the stock was watered. On the basis of book values, the answer is clearly in the affirmative. But is it the old story of the books not reflecting the facts? In this instance, such was not the case. Analysis of the earnings reveals that the corporation was worth approximately $10,000,000 (by capitalizing the net earnings at 8 per cent). If this were divided by the number of shares outstanding, the value per share would be $25, leaving net "water" of $14.50 per share on the basis of capitalized earnings.

In another similar case, shares were sold privately at $23 per share. The actual book value per share at the end of the year of the financing was approximately $10, or $13 less than the sale price. Capitalization of the earnings at 8 per cent for that year, however, showed a valuation of $33 per share. From the standpoint of the books, the stock may be said to be watered; but in terms of earnings, the stock was more than protected by equivalent value.

Much perplexity arises because of the impossibility of reaching a final and absolute answer, but it is the nature of value to be variable in character. It changes with time, varies according to personal opinion, and shifts along with the basis of valuation which is used. Arbitrary authority may sanction or approve a given figure, but this by no means assures its accuracy. To illustrate, the treatment by the Securities and Exchange Commission of an application to sell certain securities may be noted. The company proposed to offer 59,550 shares of stock at a price of $29.50 per share, as well as offering $304,000 in bonds. Certain interests claimed that the price of the stock was too high, while others countered with the claim that it was too low. To sustain the charge that the price was too high, the following valuations were reported:

1. Book value of property, plant, and equipment less retirement reserves .... $11.44 per share
2. Value based on rate established by the state regulatory commission .... $16.70 per share
3. Reproduction price installed, per report of experts, less retirement reserves .... $19.54 per share
4. Depreciated cost installed, per report of experts .... $ 8.67 per share

Recognizing the impossibility of reaching a value that would be accepted as fair by all groups, the Securities and Exchange Commission approved the sale on the condition that the prospectus include certain relevant portions of its findings and on the grounds that the price of $29.50 appeared reasonable in relation to earnings.[11]

Conclusions as to Watered Stock. Broadly speaking, it may be said that the primary test of watered stock is found in the intent of the promoters who sell the stock. If there is a deliberate attempt to milk the stockholders by the inflation of the value of the assets, a watered condition is the inevitable result. In the cases cited above, "water" would seem to exist in the sense of absence of equivalent value; but the intention of deceptive overstatement of the security values is by no means clear. Rather, it would appear that the issuers were simply trying to realize the maximum price for their holdings, just as any person would seek to obtain the best price when selling in the market. Apparently, the Securities and Exchange Commission held a similar attitude since, in one of the instances reported, it allowed the offering price to remain in the prospectus.

ANALYSIS OF THE COMPOSITION OF CAPITALIZATION

The framework or composition of capitalization is generally regarded to be the result of planning by management, but often it is the product of opportunism arising out of conditions in the investment market. At times, management may choose to take advantage of low money rates mainly because of the availability of cheap capital; at other times, its actions may be the result of compelling necessity. The heart of long-term financial planning is found in the relative use of stocks and bonds. And, probably of increasing significance, there is the question as to how much reliance should be placed upon surplus earnings as a source of capital.

When management has a range of choice in constructing its capitalization, it is faced with conflicting objectives. If maximum security is being sought, greater emphasis would be placed upon common stock as a source of funds. However, if the goal is to realize larger profits for the stockholders, then the management may elect to take the chance of issuing bonds at a lower rate so that the differential would accrue to the common stock. To take a simple illustration, we may note the effect of using bonds upon the profits accruing to the common stock account as follows:

[11] *Wall Street Journal,* May 31, 1939, p. 5; or *Opinion of SEC on Newport Electric Corporation,* rendered May 22, 1939.

Explanation	Assumption A	Assumption B	Assumption C
Total assets	$10,000,000	$10,000,000	$10,000,000
Capitalization:			
4% bonds	....	2,000,000	5,000,000
Common stock	10,000,000	8,000,000	5,000,000
Assumed net operating income	1,000,000	1,000,000	1,000,000
Less: Interest charges	....	80,000	200,000
Available for common stock	1,000,000	920,000	800,000
Rate of return	10%	11.5%	16%

Assuming that management is in a position to choose between stock and bonds as a source of new capital, it is faced with the following conflicts of thought:

1. There may be a reluctance by stockholders to have more stock issued because of the resulting diversion of a proportionate share of the earnings to newcomers who had not assumed the earlier risks.
2. While bonds may be sold at a given time at a lower rate than the dividends on stock, the former create all the hazards of annual fixed charges and, ultimately, the payment or discharge of the obligations at maturity.

In reaching a decision, the relative benefits and risks are evaluated, and it is likely that the answer would be determined on the basis of conditions then prevailing in the capital market.

The meaningful term "trading on the equity" is commonly used to designate the policy of borrowing money. As used in this connection, the term "equity" refers to the stock or ownership of a corporation; and the trading feature is simply one of taking advantage of the permanent stock investment to borrow funds on a favorable basis. It is anticipated that there will be a differential between the rate of interest and the rate of earnings which would add further to the profits of the stockholders. Trading on a thin equity means that the amount of borrowing is relatively large in proportion to the capital stock; and, vice versa, trading on a thick equity exists when the borrowed funds are comparatively small in relation to the stock base. Operating on a thin equity may present a greater opportunity for profits from this source; but, at the same time, it may be the cause of excessive risk because of the contractual character of the interest payments and principal maturities. A balancing of the long-term risks against a profit advantage which may be of short duration is involved.

Another term which is used to describe the use of the ownership account as a basis for borrowing is "leverage"; in addition, it refers to the pyramiding of corporate layers so that a successively smaller amount of stock gains control of the subsidiary companies. As a result, earnings or losses of the top companies increase or decrease in greater proportion than those in the lower levels. Trading in the securities of such companies

is frequently encouraged because of this cumulative effect, and it is not surprising that leverage is more frequently associated with the activities of speculators and investors than with financial management.

AN ACTUAL CASE

In order to show the functioning of trading on the equity in actual practice, reference may be made to a well-known corporation which obtained approximately 70 per cent of its capital from ownership sources and the remaining 30 per cent from loans of various types. The company had an indebtedness of $161,434,148 and combined stock and surplus of approximately $414,000,000. In a favorable year, its net earnings amounted to $53,460,160 after allowing for depreciation but before accounting for interest on the debt. The rate of earnings on the combined investment was, therefore, 8.9 per cent; however, since the bonds received only $11,217,180 and the preferred stock $7,000,000, the entire balance of about $35,000,000 was available for the common stock. The result was a net return of 11.2 per cent, which was well in excess of the over-all rate of earnings on the capital as a whole.

The operations of the same company also show how trading on the equity may prove to be unprofitable to the common stockholders. In another year, the net profits amounted to only $13,294,524, or 4.5 per cent of the total capitalization (stock plus bonds). After allowing $8,689,193 for interest on the funded debt and $3,662,310 for preferred dividends, there was available only $943,021 for the common stock, or 1.2 per cent on the investment. If all the capital had been raised by common stock instead of by the financial setup existing at the time, it is apparent that the rate of earnings on the stock would have been 4.5 per cent instead of the 1.2 per cent actually realized.

On other occasions, of course, there may be a loss before allowing for the fixed charges due on the funded debt. This condition developed for the same company in the disastrous year of 1932; and, needless to say, there were many other concerns in similar distress. Continuance of such results over a period of time is inevitably the cause of default and failure and is a forceful reminder of the hazards of trading on the equity.

REQUIREMENTS FOR TRADING ON THE EQUITY

Because losses may occur from time to time and, under certain circumstances, may continue for a number of successive years, it is essential that bonds be used as a source of capital only after careful consideration has been given to various factors which have a bearing upon safe and sound operation. A company whose earnings are reasonably stable may be justified in trading on a reasonable equity basis; but if the earnings are subject to violent fluctuations, borrowings should be resorted to on a

limited scale, if at all. The rigid, contractual demands of interest payments must be met regularly if failure is to be avoided. A company borrowing with a thick equity has a large ownership account upon which there is no binding obligation to pay any return, thus leaving all its available earnings to pay the interest on a relatively small amount of borrowing. Conversely, the corporation with a large amount of indebtedness is under constant pressure to earn a return sufficient to cover the interest cost of such funds.

A second feature which often favors trading on the equity is a large investment in fixed assets. Large amounts of fixed property constitute a valuable adjunct for borrowing money, since they give the lender a feeling of security and an assurance that the company will not vanish overnight. Frequently, stable earnings and large fixed assets accompany each other. The public utilities borrow rather heavily and are a good example of a combination of stable earnings and a large amount of fixed assets.

A third requirement for satisfactory trading on the equity is that the field of enterprise be well established. The new and untried field should be financed with a plan that imposes as little hardship as possible and one that does not require management to face the necessity of meeting heavy fixed charges on a given date. A good rule would be the avoidance of large-scale borrowing until at least one business depression has been weathered successfully; unfortunately, pressing expediency is often the cause of violation of this rule.

By narrowing these general statements with respect to trading on the equity, we may observe that two specific tests are applicable to all types of companies: (1) the adequacy and stability of net income in meeting the recurring fixed interest charges on funded debt and (2) the assurance of developing a financial position which can stand the shock of the maturities of the principal indebtedness.

As to the first point, it should be noted that proper allowance must be made for the fluctuations in earnings in order to cover the fixed charges in periods of adversity. The accepted standards vary according to the field of enterprise; but, generally speaking, the ratio of the net income to the fixed charges (interest) should seldom be less than 2 to 1. It is not feasible to speak so exactly about the second test because its application often awaits the expiration of a long maturity. Granted that the corporation may expect to refund the obligation instead of liquidating it, there is nevertheless hazard in relying too fully upon this alternative. Capital-market conditions may be unfavorable; and, in addition, any form of financing depends upon the financial position of the issuing corporation.

THE INDUSTRY PATTERN

To show the extent to which the various industries resort to borrowing as a means of raising capital, Table 16 presents the distribution of financ-

ing according to funded debt, preferred stock, common stock, and surplus. In railroads and other public utilities, it is apparent that bonds play a much more prominent part as a source of funds than they do in industrial companies. There is less uniformity of pattern for the latter, but, in general, there is less resort to trading on the equity. Favorable capital-

TABLE 16

TOTAL CAPITALIZATION BY INDUSTRIES*

(For the Period, July, 1957—June, 1958)

Type of Industry	Total Amount of Capitalization (In Millions)	Distribution According to Source (In Millions): Bonds, Notes, and Mortgages Payable (Maturity One Year or More)	Preferred Stock	Common Stock	Surplus Reserves, Surplus, and Undivided Profits
All manufacturing	$175,308	$29,032	$6,390	$39,805	$100,081
Food and kindred products	11,003	1,657	614	2,817	5,915
Tobacco manufactures	2,343	578	210	555	1,000
Chemical and allied products	16,971	3,307	729	3,239	9,696
Rubber products	2,887	731	115	374	1,667
Motor vehicles and equipment (except electrical)	11,702	1,267	382	1,335	8,718
Primary metal industries	19,001	4,083	932	3,718	10,268
All public utilities	106,878	45,905	5,351	26,999	28,623
Transportation	38,919	14,073	864	8,462	15,520
Communication	20,869	7,575	329	8,287	4,678
Electric and gas	45,685	23,580	4,050	9,942	8,113
Percentage distribution of sources:					
All manufacturing	100.0	16.6	3.6	22.7	57.1
Food and kindred products	100.0	15.1	5.6	25.6	53.7
Tobacco manufactures	100.0	24.6	9.0	23.7	42.7
Chemical and allied products	100.0	19.5	4.3	19.1	57.1
Rubber products	100.0	25.3	4.0	13.0	57.7
Motor vehicles and equipment (except electrical)	100.0	10.8	3.3	11.4	74.5
Primary metal industries	100.0	21.5	4.9	19.6	54.0
All public utilities	100.0	43.0	5.0	25.2	26.8
Transportation	100.0	36.2	2.2	21.7	39.9
Communication	100.0	36.3	1.6	39.7	22.4
Electric and gas	100.0	51.6	8.9	21.8	17.7

* U.S. Treasury Department, Bureau of Internal Revenue, *Corporation Tax Returns, 1957–58* (Washington, D.C.: U.S. Government Printing Office, 1960), pp. 32–35.

market conditions and the urgent need for funds to finance the large-scale expansion in recent years have accelerated the use of borrowed money by industrial companies, but it is still at a lower level than that for companies of the public-utility type. Also, it should be stated that in all instances the results are, in part, the product of compulsion rather

than choice. The money market is a hard taskmaster, and financial planning is at best a compromise with its demands.

THE INFLUENCE OF SIZE AND SUCCESS OF OPERATION

It is also likely that the size of corporations and the success of their operations have a bearing upon the financial structure. Small companies have difficulty in tapping the national investment market and are often compelled to resort to measures of expediency. They may even resort to short-term debt as a substitute for long-term financial arrangements. Although the former is not a form of capitalization in the true sense of the word, it is used in this capacity because of inability to sell either bonds or stocks. The use of current financing to cover long-term needs

TABLE 17

DISTRIBUTION OF SOURCE OF FUNDS, JULY, 1957–JUNE, 1958, FOR ALL MANUFACTURING COMPANIES WITH FEDERAL INCOME TAX RETURNS*

Asset Class	No. of Companies	Sources of Funds (In Millions)			Percentage Distribution		
		Current Debt	Long-term Debt	Net Worth	Current Debt	Long-term Debt	Net Worth
$0–$50,000	43,349	$ 367	$ 138	$ 291	46.1	17.3	36.6
$50,000–$100,000	21,871	486	179	741	34.6	12.7	52.7
$100,000–$250,000	28,252	1,213	468	2,371	30.0	11.5	58.5
$250,000–$500,000	16,190	1,411	547	3,116	27.8	10.8	61.4
$500,000–$1,000,000	10,027	1,529	552	4,117	24.7	8.9	66.4
$1,000,000–$5,000,000	10,284	3,749	1,587	13,586	19.8	8.4	71.8
$5,000,000–$10,000,000	1,543	1,558	934	7,194	16.1	9.6	74.3
$10,000,000–$50,000,000	1,513	3,730	3,344	20,937	13.3	11.9	74.8
$50,000,000–$100,000,000	256	1,883	2,431	11,694	11.8	15.2	73.0
$100,000,000 and over	273	12,508	18,852	82,229	11.0	16.6	72.4

* U.S. Treasury Department, Bureau of Internal Revenue, *Corporation Tax Returns, 1957–58* (Washington, D.C.: U.S. Government Printing Office, 1960), p. 44.

is essentially a means of improvisation and is justified by its sponsors because of the absence of alternatives and the hope or expectancy of quick profits in an amount sufficient to provide funds to retire the debt. Or it may be possible to "roll over" the debt, i.e., to renew it at maturity, or to replace it with a new obligation. Similarly, meager success may force companies, both large and small, to resort to either long- or short-term debt because of inability to obtain capital by the sale of stock. Such tendencies may be seen in Table 17, which shows the percentage of distribution of the sources of funds according to current debt, long-term debt, and net worth for all manufacturing companies filing federal income tax returns from July 1, 1957 to June 30, 1958.

Upon analysis, it will be seen that the amount of current debt varies inversely with the size groupings of the companies while long-term debt is proportionately larger at both ends of the scale. Also, it should be

stressed that there may be wide variation among individual member concerns within the same size classification. For example, as of a recent date, two companies with comparable assets of $1,315,000 and $1,566,000 obtained their funds as follows:

	Company A	*Company B*
Current debt	15.9%	22.0%
Long-term debt	5.2	27.6
Net worth	78.9	50.4

Because of the possible wide difference in pattern, even within the same size grouping, it is likely that Table 17 is more descriptive than significant as a principle or guide for the formulation of a plan of financing.

IS PREFERRED STOCK A FORM OF TRADING ON THE EQUITY?

Up to this point, the concept of trading on the equity has been limited mainly to the use of bonds. From a practical standpoint, however, the question may be raised as to whether preferred stock may not fall into a similar category. With its stated dividend rate and frequent provision for redemption, preferred stock may be treated in much the same light as bonds. From the point of view of the bondholders, no "trading" is involved because of their priority of claim for both interest and principal; but, from the standpoint of the common stockholders, the opposite conclusion has much justification.

Fundamentally, a distinction between the legal and economic aspects of the question is necessary. Legally speaking, preferred stock cannot be considered as trading on the equity; it would be more accurate to substitute the term "borrowing" for "trading on the equity." The latter term is used in finance to indicate the intent behind the borrowing and is mainly descriptive of an operation. Despite the tenuous basis of the terminology, economic analysis gives reasonable grounds for treating preferred stock as a form of trading on the equity. Preferred stock has a degree of priority in its claim against the assets and differs in many respects from common stock. It has a stated dividend rate, and its payment is the normal expectancy of a going concern. For most preferred issues, excess earnings above this dividend rate go to the common stock. The result is in reality a form of trading on the equity by the common stockholder, i.e., offering the preferred group a fixed rate with the common's equity acting as a reserve to give the promise meaning. Similarly, there are many features relating to the principal which are typical of borrowing operations. If there is a sinking fund, or if the policy calls for redemption of the principal, a form of trading on the equity exists.

IS SURPLUS A PART OF CAPITALIZATION?

As the term is used on the "street," surplus or retained earnings are generally not regarded as a part of capitalization. Funds from this source

cannot be raised in the same sense as from issuance of securities, and their availability obviously varies in keeping with the degree of business success. However, we may explore the thought that, in substance or final result, surplus is an integral and expected part of capitalization. To begin, one must have clearly in mind the nature of the surplus account. Although many kinds of special surplus accounts may be created, usually they may be classified into the following two major categories: (1) some form of capital surplus, (2) some form of earned surplus.[12]

Capital Surplus. Capital surplus arises from sources other than current operations. Perhaps the most typical sources of such surplus may be found in the reduction of the book value of stock or in the sale of stock at a price in excess of par or stated value. In the sale of par stock, the excess is usually called "capital surplus" or "premium on stock"; in the case of no-par stock, the term "paid-in surplus" is common. Other sources are donations of stock and assets to the corporation, assessments upon stock, or gains on the purchase or sale of treasury stock. To these should be added surplus arising from mergers or the reorganization of insolvent concerns, and the amount due to an appreciation in the value of assets.

Under certain circumstances and under some state laws, it may be possible to declare dividends out of capital surplus; but such is not the normal expectation. Nor is it usually possible. Instead, surplus of this type will be held in the business as a means of facilitating long-time operations. Under these circumstances, it is an integral part of the long-time financial structure of the corporation and may logically be classified as a part of the capitalization. This conclusion is applicable only in a financial or an accounting sense; when viewed in a legal light, capital surplus may not be so considered.

Earned Surplus. Earned surplus is the accumulation of net earnings which are allowed to remain in the business. This means that its original source is to be found in the current operation of a business enterprise. Although the source of this surplus is in current activities, it does not necessarily follow that earned surplus may not be regarded as a part of the long-time financial program. A more satisfactory criterion for determining the classification of surplus would be found in the intentions of the management as to the disposal of the surplus. If the management plans to retain surplus in the business, it should be treated as a part of the capitalization just as much as is common stock sold to the public. Both items (common stock and earned surplus) are simply means of raising capital and may well be placed in the same general category of capitalization.

To this argument, it may be replied that the surplus may be disposed

[12] Under current terminology, the term "earnings retained in the business," or similar phraseology, is commonly used instead of "earned surplus." See Chapter 25.

of and used for dividend distribution. However, for the typical going concern, this would not be the practice usually applied to the bulk of the surplus. The mere fact that surplus has been set up at the outset means that it is above the regular distribution. Moreover, earned surplus is the usual basis for declaring stock dividends, which, in turn, are recognized universally as part of the capitalization upon completion of the formal issuance of the stock.

The point may be illustrated by the 40 per cent stock dividend of the United States Steel Corporation in 1927. The common stock was increased from $508,302,500 to $711,623,500, and the surplus account was reduced by the difference. From the legal point of view, such transposed surplus became an integral part of the capitalization; but from the standpoint of the long-time financial plan, little change was effected. It is more than likely that the original surplus was regarded as a permanent part of the financial structure, a conclusion that is supported by further analysis of the surplus account. From 1918 through 1929, the undivided surplus account was less than $400,000,000 only in the year 1927, when the stock dividend was declared. This means that over a long period of time one major source of capital funds was surplus earnings which were kept in the business. Under such a policy, it is entirely logical to regard earned surplus as a part of the capitalization.

The argument is even more convincing when applied to appropriated surplus. For many years, the United States Steel Corporation carried an account entitled "appropriation for additions and construction." Beginning with 1918, this account was never less than $110,000,000; and from 1926 to 1934, it amounted to $270,000,000.[13] For a considerable period of time, the Bethlehem Steel Corporation had a similar account designated as "appropriated surplus"; but in 1931, it was merged with general surplus.[14] Since the act of appropriation for specific uses destroys the availability of surplus for dividend purposes, the earmarked account really becomes a part of the long-time financial plan.

Later we shall consider more fully the use of retained earnings to finance capital outlays, but may note at this point an example of their importance. During the years 1921–38, the United States Steel Corporation made capital outlays of $1,606,000,000 for plant and equipment and the retirement of debt. Of this large sum, only $239,950,000 was obtained from the sale of securities; the remainder came from reduction in working capital, tax refunds, and earnings. With respect to the last

[13] The account was closed out in 1935 through the transfer of $88,720,028 to the reserve for depreciation and depletion and the balance of $181,279,972 to the amortization reserve. These transfers did not withdraw capital from the business in any way. Capital stock could similarly be reduced in book value and the amount of the reduction transferred to valuation reserves.

[14] From 1917 to the date the account was closed, the balance was never less than $47,500,000.

source, distinction should be made between accretions to capital and charges which provide for its maintenance. The latter is accomplished by the familiar allowances for depreciation and depletion; in the subject case, they accounted for 58 per cent of the indicated capital outlays.[15]

SUGGESTIONS AS TO SOURCES OF FUNDS

Although it is impossible to lay down any fixed rules as to the choice of the various media of raising funds, expression may be given to the following tentative principles:

Bonds. Ideally, bonds should be issued only when the earnings outlook appears to be reasonably steady and assured. At the same time it should be recognized that capital-market conditions may give management little choice and compel the issuance of bonds instead of stock. There are numerous examples of such financing by new companies, but, in recent years, there has been a marked tendency to make the bonds convertible. By means of this latter feature, the indirect building of the ownership base can be enlarged when the operations are successful.

Preferred Stock. Again there is the lure of dovetailing corporate needs into the capital-market pattern. From the management point of view, the issuance of preferred stock is warranted whenever it appears that the earnings are sufficient over a period of time to cover the dividend requirements; otherwise, accumulated unpaid dividends can be the cause of adjustment, including possible changes in management.

Common Stock. Common stock necessarily appears in all corporations and should be used as much as possible to provide a solid basis for other financing. Enterprises involving high risk should use common stock exclusively, and all corporations should use it extensively as an evidence of belief in the project. The acceptance by investors of this residual risk is, of course, encouraged by the prospects of higher yields than are normally returned on bonds or preferred stock.

Surplus. Since surplus is not raised in the sense of a security flotation, it is obviously not available to meet new capital needs of the moment. However, its steady accumulation is vital to sound business operation. More than a source of funds, it also serves as a cushion to absorb possible losses.

SUMMARY COMMENTS

The most realistic concept of capitalization may be found in the recognition of its basic function—provision for the long-term financial needs

[15] Temporary National Economic Committee Hearings, *Savings and Investment*, Part IX (Washington, D.C.: U.S. Government Printing Office, 1939), pp. 3580 and 4026.

of a corporation. Short-term needs should normally be met by current financial arrangements, as described more fully in Chapters 26 and 27, although, somewhat paradoxically, there are some long-term needs attending the maintenance of a sound, current financial position. Overall planning is necessary in order that the requirements for plant investment and other long-term investments may be properly co-ordinated with the current outlays and thus assure sound, financial administration in its largest sense. However, the key to financial success is found in the capitalization, since it is the strong foundation upon which most financial arrangements rest. At the same time, revisions of the capital structure are continually taking place in order to meet the changing needs of the corporation itself and to respond to changing economic conditions. Such changes in capitalization will be discussed at length in the succeeding chapter.

QUESTIONS AND PROBLEMS

1. Why may it be difficult to synchronize "financial accommodation with operating or asset needs"?
2. "The plan of financing can easily become a burden instead of a tool." Explain and discuss.
3. Discuss the meaning of the term "capitalization," and distinguish between the qualitative and quantitative applications to the corporation.
4. Evaluate the deficiencies of capitalization as a measure of the value of a corporation.
5. Discuss the problems of formulating a plan of capitalization for (*a*) a newly created enterprise and (*b*) an established company.
6. In early 1955, a company was organized, issuing 100,000 shares of common stock at $1.00 per share. Shortly thereafter, it borrowed approximately $10,000,000 to buy the stock of an existing company; then, to retire the indebtedness, it sold 500,000 shares of additional common stock to the public at $23.50 per share. Do you think the public stockholders received "equivalent consideration"? Discuss the legal, ethical, and financial merits of this plan of financing.
7. Discuss the statement in the text that market value tends to "be less than the book figure when prospects are unfavorable."
8. Discuss the nature of "trading on the equity," and comment on its relationship to capitalization. Do you think that corporations should deliberately "trade" on the equity? If so, under what conditions?
9. "Corporation laws require authorization for the issuance of stock, but no approval is necessary for the issuance of bonds or assumption of other indebtedness. Government has seen fit to regulate the latter in the case of railroads and public utilities but industrial companies are free to incur indebtedness on their own initiative." Discuss the difference in treatment of the three fields of enterprise, and evaluate the merits of requiring approval of stock issues and not providing similar authorization of bond issues.
10. Two companies operating in the chemical field are capitalized as follows (as of December 31, 1959):

	Olin Mathieson Chemical Corporation	Union Carbide Corporation
Long-term debt.............	$334,425,894	$446,791,096
Common stock.............	66,921,930	242,760,989
Earned surplus.............	202,755,734	685,493,989
Paid-in surplus.............	106,177,820	—

Discuss the following features (see *Moody's Industrial Manual*): (*a*) the composition of the long-term debt, (*b*) the comparative merits of the two plans of capitalization, (*c*) the earnings of the two companies for the last five years, and (*d*) the reasons for the differences in the capital structures.

11. Compare and evaluate the capital structures of the National Steel Corporation and the Kaiser Steel Corporation (see *Moody's Industrial Manual* for information).
12. Evaluate the merits of a policy of writing down the values of assets in order to create hidden reserves.
13. Discuss the meaning and significance of watered stock.
14. Discuss the relative importance of surplus as a part of the capitalization (*a*) in small and large industrial companies, (*b*) in public utilities, and (*c*) in railroads.
15. "Beyond a prescribed minimum size, the financial plan of all corporations should be approved by a qualified regulatory body as a means of protecting the public interest." Discuss.

REFERENCES

BONBRIGHT, JAMES C. "Valuations," *Encyclopaedia of the Social Sciences,* Vol. XV, pp. 212–17.

BONNEVILLE, JOSEPH H., and DEWEY, LLOYD E. *Organizing and Financing Business,* chap. xii. New York: Prentice-Hall, Inc., 1952.

DODD, D. L. *Stock Watering: The Judicial Valuation of Property for Stock Issue Purposes.* New York: Columbia University Press, 1930.

FOWLER, TITUS W. "Planning a Utility's Financing Program," *Investment Dealers' Digest* (June 5, 1961), sec. 2, pp. 38–41.

GLAESER, M. G. "Capitalization," *Encyclopaedia of the Social Sciences,* Vol. III, pp. 208–11.

LORE, MARTIN M. *Thin Capitalization.* New York: The Ronald Press Company, 1958.

PINES, J. ARNOLD. "Should Electric Utilities Moderate Their Debt Financing?" *Commercial and Financial Chronicle,* Vol. 193, No. 6058 (May 25, 1961), pp. 3, 24–25.

SCHWARTZ, ELI. "Theory of the Capital Structure of the Firm," *The Journal of Finance,* Vol. xiv, No. 1 (March, 1959), pp. 18–39.

Stevens on Corporations, secs. 172–73. St. Paul: West Publishing Co., 1936.

STEVENSON, HAROLD W. *Common Stock Financing.* Ann Arbor, Mich.: Bureau of Business Research, School of Business Administration, University of Michigan, 1957.

Chapter 13 ►

CHANGES IN CAPITALIZATION

DESPITE THE long-term nature of capitalization, it is to be expected that changes must be made at various times. First, there is need to provide funds to meet the costs of expansion. Second, revisions are warranted to improve the terms of financing or to meet special problems. Just as the physical plant and equipment may become obsolete because of improvements and new inventions, the financial pattern may also be outmoded by changing conditions in the money market. No form of planning can ever fully anticipate the effects of dynamic economic trends; and, as a result, the capitalization of a corporation is subject to rather frequent adjustment. Besides the issuance of securities to raise new capital, the actions range all the way from taking advantage of favorable financial terms to more serious financial difficulties which demand a remedy. At this time, consideration of the latter will be limited to those cases which do not involve failure and reorganization.

RECAPITALIZATION AND READJUSTMENT

Usually, the terms "recapitalization" and "readjustment" of the capital structure are considered to be the result mainly of a state of financial embarrassment; but, as used here, they will be employed generally to cover all changes, irrespective of source. Also, the terms will be used interchangeably, even though many writers draw a distinction between the two. When this delineation is made, readjustment is considered to be a major transition and change in the composition of the financial plan, whereas recapitalization is interpreted as a simple amendment of the original plan, such as increasing the number of shares of stock or changing the amount of stated capitalization.

Practice shows, however, that the distinction between the two terms is mainly one of degree or personal opinion and that the same financial means may be used in either case. Thus, stock dividends would usually be regarded as a minor revision; but they may also be used to accomplish a fundamental change in financial policy. For example, a closed corpora-

tion, in order to facilitate the sale of its shares to the public, may lower their unit value by payment of a large stock dividend. Because of this difficulty in distinction, the terms will be used synonymously; the changes involved in readjustment and recapitalization will be thought of as one group; and those caused by actual failure will be considered in a later section dealing with major reorganization.

ADVANCE PROVISION FOR RECAPITALIZATION

Once considered to be an abnormal circumstance, recapitalization is now being facilitated by advance planning. It is likely that the financial difficulties of the thirties emphasized the need for an "open-door" financial program; and certainly the acute problems of that early period brought into sharp focus the fact that management and creditors have common elements of welfare. As a result, security indentures now generally provide for the submission of changes to security holders in order to avoid the cost and inconvenience of more drastic action. We may use the concise words of *Moody's Manuals* to illustrate the essence of one means of providing for such action—the "indenture may be modified, except as provided, with the consent of 66⅔% of debentures." When there is use of private placement of funds, direct negotiation for changes in terms is even more convenient. In short, whether funds are raised privately or publicly, it is realized that it is virtually impossible to anticipate the contingencies of long maturities; and common sense reveals the practicality of arrangements for changing loan terms and conditions without resort to the drastic effects of legal reorganization of the corporation.

The force and effect of a modification agreement as well as of negotiation may be illustrated by the changes in financing effected by the Goodyear Tire & Rubber Company. In 1938, it sold privately its first and collateral 3½'s, due in 1958, to retire a similar 5 per cent issue which matured in 1957. The indenture provided for modification upon a two-thirds vote of the outstanding bonds; but it was stipulated that no change could be effected which would (1) create a prior lien or charge, (2) postpone the maturity or payment of interest, or (3) reduce the principal or rate of interest. However, in 1945, by negotiation and the use of a supplemental indenture, the maturity was extended to 1964 and the rate of interest reduced to 2¾ per cent beginning on June 16, 1950. However, in 1947, unsecured 2¾ per cent notes, due serially to 1964, and unsecured 3 per cent notes, due serially to 1967, were issued, and the proceeds were used to retire the first and collateral bonds, for capital expenditures, and to increase the working capital.

CHANGE WITHOUT INDENTURE AGREEMENT

Besides the specific provision for modification of security terms which may be included in an indenture, it should be noted that corporation laws

have also been liberalized to facilitate change in the capital stucture. Early statutes often required 100 per cent approval by the stockholders to effect a revision of the capital stock, but now it may be done upon ratification by a specified majority vote. As a result, management may seek the approval by stockholders of actions that are not within the power of the directors. For example, the Westinghouse Electric Corporation revised its capitalization in 1946 when the stockholders approved a plan to merge two wholly owned subsidiaries and to eliminate the non-callable, participating, cumulative 7 per cent preferred stock with a par value of $12.50. Holders of the latter were offered, for each share held, one-quarter of a share of 3½ per cent cumulative preferred, Series A, with a par value of $100 (redeemed in 1950 at $104) and one-half share of common with a par value of $12.50. The plan also provided for a change in the name from Westinghouse Electric and Manufacturing Company to its present shorter title.

These facilities for changing the capitalization of a corporation suggest that management almost always has the advantage of being on the offensive in its dealings with security holders. Also, investment bankers, who quite naturally seek to promote their own business, constantly seek to develop opportunities that favor the corporation. On the receiving end of the line, the investor has little escape from his defensive position. In periods of easy money, management naturally resorts to the refunding of high-rate issues by exercising the call privilege; whereas it continues low-rate securities when money is tight. Yet the pattern is likely inevitable—the product of a free market.

PROCURING FUNDS FOR EXPANSION

The importance of the role of retained earnings as an integral part of the capitalization, or financial plan, of a corporation is vividly revealed by both specific example and business in the aggregate. For the former, the record of expansion of the United States Steel Corporation may be noted for the five-year period, 1954–59 inclusive. As may be seen in Table 18, the gross expansion of its plant, property, and equipment account amounted to $1,530,604,298, and funds for future expansion were segregated in the amount of $495,000,000. Funds realized from depreciation charges and retained earnings, alone, were almost sufficient to finance the operation. With respect to the depreciation charges, it may be noted again that they serve mainly to preserve the integrity of earlier capital outlays; at the same time, any funds materializing from such allowances may be diverted to new plant development. In the case under consideration, external sources accounted for the additional expenditures and also provided funds for current and other miscellaneous purposes.

The picture for American industry generally may not be pinpointed so precisely, but the total need for financial accommodation may be appreciated by noting the aggregate figures for 1959 and 1960. In the

former year, it is reported that the investment in plant and equipment increased $32,540,000,000; in the latter year, preliminary estimates indicated an amount of $35,740,000,000.[1] Our visualization of the dynamics of such expansion may also be sharpened by noting the appraisal of capital needs made by one authority in 1955. He estimated that $240,000,000,000 was required to finance the expansion from 1945 to 1954, and that two-thirds of the amount was provided by depreciation allowances and retained earnings. Of the remaining balance of $80,000,000,000, it was indicated that new debt accounted for 75 per cent of the funds, and the balance by equity financing.[2]

Looking ahead to the ensuing decade, the same authority predicted a need for $375,000,000,000 to meet the costs of expansion. Commenting on the sources of these funds, he estimated that 60 per cent would come from earnings and the balance from outside sources. With respect to the

TABLE 18

SUMMARY STATEMENT OF ACTUAL AND PROPOSED PLANT EXPANSION AND SOURCE OF FUNDS OF UNITED STATES STEEL CORPORATION
1954–59 Inclusive

Gross Additions to Plant, Property and Equipment			$1,530,604,298
Funds segregated for capital expenditures			495,000,000
Total Provision for Capital Expansion			$2,025,604,298
Source of Funds			
Earnings:			
Increase in depreciation reserves	$944,473,509		
Increase in earned surplus	815,365,357	$1,759,838,866	
External Financing:			
Increase in long-term debt	$484,114,416		
Increase in common stock	19,649,384	503,763,800	2,263,602,666
Excess of Funds over Plant Additions and Proposed Expansion			$ 237,998,368

latter, it was predicted that debt financing would continue to "play a major role" but warned that it should not be "so burdensome to our corporations that they are strapped by high fixed costs that limit their flexibility." To avoid this restraint upon management as well as to moderate the pressure of debt upon the economy, the view was expressed that efforts should be made to raise 50 per cent of the external funds by means of equity financing.

Confronted by these facts, it is easy to minimize the importance of bonds and stocks as sources of funds. However, it should be remembered that they occupy a strategic position (1) in providing funds in quantity on comparatively short notice and (2) in serving as a nucleus or basis for the entire long-term financing program.

[1] U.S. Department of Commerce, *Survey of Current Business*, December, 1960, p. 4.

[2] See Keith Funston, President of the New York Stock Exchange, "Corporate Capital Needs between Now and 1965," *Commercial and Financial Chronicle*, Vol. 181, No. 5442 (June 30, 1955), pp. 3, 20–21.

In the railroad and public-utility fields, there is pronounced dependence upon the issuance of new securities to raise funds for expansion. Here, there is regulation of the service rates; and the authorities are guided, in part, by a policy of allowing only a fair return on the capital investment. As a result, a large cushion of surplus earnings for investment in plant expansion is not available. Illustrative of this condition is the record of the Pacific Gas and Electric Company for the period 1954–59, as may be seen in Table 19. During this five-year period, its earned surplus increased at a faster rate than the other reported items, but, at the same time, the combined stock and surplus account is less than its funded debt. In great contrast, earned surplus is commonly the largest single source of funds for leading industrial companies; to

TABLE 19

SELECTED ITEMS OF PACIFIC GAS AND ELECTRIC COMPANY, 1954 AND 1959*

Item	Year 1954	Year 1959	Percentage Increase
Gross revenues	$ 386,244,192	$ 583,424,782	51.1
Net income	63,039,149	84,737,102	34.4
Utility plant†	1,672,738,551	2,232,071,083	33.4
Funded debt	771,127,000	1,100,592,000	42.7
Capital stock	728,459,400	798,484,350	9.6
Earned surplus	78,575,275	178,146,131	126.6

* *Moody's Public Utility Manual, 1960*, p. 279.
† After depreciation.

cite what is likely the most outstanding example, the earned surplus of the General Motors Corporation is almost three times the combined funds realized from all other sources.

Irrespective of whether funds are obtained from the sale of new securities or from earnings, it is inevitable that expansion will bring about a cumulative and changing pattern of capitalization. More obvious, however, are the immediate and planned changes arising out of financial administration for reasons that are discussed in the following sections.

REDUCING THE COST OF MONEY AND EXTENDING MATURITIES

The money market serves in many ways as a trading arena where advantage may be taken of lower interest rates or of other benefits which are possible through financial arrangement. Management is in constant search of ways and means to effect savings in the cost of money as well as to rearrange the capital structure to gain long-term soundness. Often, these two objectives complement each other, although at times some sacrifice may be made in the first in order to achieve a more stable plan of financing—such as the substitution of stock for bonds. Changes in the capitalization may be appreciated more fully by noting the following

three types of revision: (1) the substitution of a new security for another of the same type, (2) the replacement of a senior obligation by another that is junior in rank, and (3) the substitution of a senior for a junior security.

Substitution of a New Security for Another of the Same Type. Ordinarily, the refunding of outstanding obligations, at least in a favorable market, has the dual purpose of extending the maturity of the principal and of reducing the cost of money. Transactions of the type occur in great volume and are cumulative in character. To illustrate, in 1940, the Texas Company sold its debenture 3's, due in 1965, to redeem the 3½'s, which were to mature in 1951; again, in 1946, it sold its debenture 2⅝'s, due in 1971, to refund a similar 3 per cent issue due in 1959, and for other purposes. Another example was the flotation by the Socony-Vacuum Oil Company (name changed to Socony Mobil Oil Co., Inc., in 1955) in 1946 of a 2½ per cent debenture, due in 1976, in the amount of $100,000,000 to redeem $50,000,000 of 3 per cent debentures due in 1964, and $50,000,000 of serial notes with maturities that concluded with the year 1955. Such replacements need not be confined to bonds and are also found in substituting a new preferred stock for an existing issue which carries a higher rate and other less favorable terms. As a result of relatively favorable conditions during much of the last decade, a large amount of optional refunding has been effected.

A change in the form of adding to the capitalization also takes place when short-term debt is replaced by long-term financing. It is not unusual to begin an expansion program with temporary financing and to defer changing the capital structure until the needs are more fully determined. The risks of such action are apparent, but often there may be an understanding or working agreement with financial institutions for the provision of long-term funds at the proper time. Indeed, there may be deliberate "trading" or a "rolling-over" of short-term debt in order to effect savings in interest or to work out more favorable terms. Among the many examples of long-term bonds issued to replace short-term debt are the following:

$50,000,000 Texas Company 3⅝ per cent sinking fund debentures, due in 1983, to prepay a 4 per cent bank loan and for other purposes (sold in 1958).

$75,000,000 Southern Bell Telephone and Telegraph Company 5 per cent sinking fund debentures, due in 1997, to pay advances from parent company and for construction purposes (sold in 1960).

$20,000,000 Associated Dry Goods Corporation 4¾ per cent sinking fund debentures, due in 1980, to pay loans and for miscellaneous purposes (sold in 1960).

$10,000,000 Riegel Paper Corporation 5¼ per cent sinking fund debentures, due in 1985, to pay loans and for miscellaneous purposes (sold in 1960).

$10,000,000 Daystrom, Inc. 5¼ per cent sinking fund debentures, due in 1980, to pay loans and for additional working capital (sold in 1960).

The Substitution of Stocks for Bonds. The United States Steel Corporation affords a good example of the policy of replacing senior with

junior securities. In April, 1929, it increased the authorized common stock from $753,321,000 to $1,250,000,000 and had $856,087,600 actually outstanding a year later. During the same period, the authorized preferred stock and outstanding funded debt were reduced considerably. The amount of preferred stock authorized was reduced from $550,000,000 to $400,000,000 in April, 1929. During 1929, the funded debt was reduced from $456,602,415 to $112,257,978. This reduction was accomplished by the use of funds obtained from the increased common stock and by the use of sinking funds and other sources of cash. The operation reduced fixed charges by $20,000,000 annually and was of material assistance in weathering the lean years of 1931–36. The policy of reducing the funded debt was reversed in 1938, when the company issued $100,000,000 in 3¼ per cent 10-year bonds. These bonds were issued to repay bank loans of some $50,000,000, and the balance was added to cash funds which were later used for plant expansion; in 1940, the debentures were retired through the sale of serial debentures carrying an interest rate graduated from 0.625 per cent in 1941 to 2.65 per cent in 1955. Continuing this policy of raising capital by funded debt, new debenture 1.30's to 2.65's, due serially to 1964, were issued in 1954 to restore working capital used in expansion and modernization programs. In 1958, sinking fund debenture 4's, due in 1983, were isssued to restore in part working capital expended for plant expansion and other miscellaneous purposes. Again, in April, 1961, a $300,000,000 issue of similar 4½ per cent debentures was sold.

The wisdom of this flexible policy is apparent. Fixed charges were replaced in 1929 with those of a more optional nature, and the general financial position of the company was strengthened. This action was facilitated by the prevailing market conditions, which offered a ready sale for common stock. Conversely, in 1938, there was no great demand for equity issues; but low-interest-rate bonds of leading corporations could be sold quite readily. To a certain extent, the 1938 borrowing operation was made possible by the strengthening of the equity base in 1929.

Speaking more generally as to financial policy, it is sometimes stated that a corporation should keep its best securities (or a portion of them) for its last or emergency needs. While this policy constitutes a most conservative safeguard against future contingencies, it is not followed widely in actual practice. Securities issued when the money market is not favorable or when the corporation is not in a satisfactory position for financing must of necessity be limited to a small number of cases. To carry the junior issues over a long period of time would mean imposing a considerable burden in the form of fixed charges upon the corporation, much of which could be avoided with the use of high-grade securities. A preferable policy would be for the corporation to arrange a financial pattern which would provide the lowest-cost financing for normal operations but at the same time to attach the call privilege so that future action would be possible to take advantage of more favorable market conditions.

The Substitution of a Senior Security for a Junior Security. It is usually regarded as unwise to replace a junior security with a senior security. Instances of the practice are rare; and, for the most part, this policy has been utilized only by a few of the larger companies which were in excellent financial position and which had little reason to fear their future ability to pay the fixed charges. The case of the Standard Oil Company of New Jersey is illustrative. In December, 1926, it issued $120,000,000 of 5 per cent gold debenture bonds[3] to obtain funds to assist in the retirement of the 7 per cent preferred stock then outstanding. As a result of the acceptance of a more rigid liability, the corporation was able to effect an annual saving of 2 per cent on $120,000,000.

An historical instance of this policy, and one involving many legal difficulties, is that of the United States Steel Corporation, which in 1902 substituted bonds for preferred stock on a rather extensive scale.[4] It proposed to change the old capitalization, which consisted of approximately $300,000,000 in bonds, $500,000,000 in preferred stock, and $500,000,000 in common stock, by issuing $250,000,000 of additional bonds to raise funds for the retirement of preferred stock in the amount of $200,000,000, with the balance to provide additional cash. Certain stockholders objected strenuously to the plan and brought suit in the courts to restrict the action. Among other complaints, it was pointed out that members of the underwriting syndicate were also members of the board of directors of the corporation and that a contract that is to the personal advantage of any director is voidable. However, this contention was counteracted by the fact that the required majority of stockholders had formally approved the refinancing program. This substitution of bonds for preferred stock makes an interesting contrast to the more recent policy of the corporation. In 1902, the corporation was only in its second year of existence; yet, it assumed the risk of replacing preferred stock and optional charges with bonds carrying fixed charges. In 1929, when the company had obtained a position of world leadership and was in an excellent position to have bonds as part of its financial plan, it retired its funded debt in favor of equity securities.

An unusual example is found in the retirement of the 4 per cent cumulative, convertible preferred stock of the Jack and Heintz Precision Industries, Inc., in December, 1950. The stockholders approved a plan for the purchase of one-half or more of the 69,365 outstanding shares in the market (later accomplished at an average price of $42.20 per share), for elimination of the accrued dividends of $7.50 per share, and for conversion of the remaining stock on the basis of 7 shares of common for each share of preferred. To obtain the funds to buy the stock, the com-

---

[3] These bonds have since been refunded through the flotation of another issue bearing a lower rate of interest.

[4] W. Z. Ripley, *Trusts, Pools, and Corporations* (Boston: Ginn & Co., 1916), pp. 228–41.

pany arranged a $1,500,000, 5-year, mortgage loan at 3⅞ per cent interest. The loan was payable $150,000 by June 30, 1951, and $75,000 quarterly thereafter, with provision for additional payments based upon earnings. The plan did eliminate the problem of accumulated unpaid dividends, but at the risk of assuming mandatory debt payments and annual fixed charges. In this instance, the decision proved its merit because the debt has since been retired.

SIMPLIFYING THE CAPITAL STRUCTURE

At best, the capitalization of a corporation is a mixture of planned effort and response to pressing expediency. Rapid growth may be the cause of getting funds by the "fustest and mostest" route; maturities may occur when money-market conditions are unfavorable; and immature corporations may be compelled to assume burdensome terms in order to raise any capital. The result is a variety of securities that may be sold at different times and in amounts not sufficiently large to develop the best market response. To correct the hybrid pattern, corporations occasionally need to simplify their capital structure as well as to "consolidate their position." For example, at the close of 1923, the General Motors Corporation had the following issues of preferred stock outstanding:

6 per cent preferred	$16,183,400
6 per cent debenture	60,801,000
7 per cent preferred	32,931,600

In June, 1924, the stockholders ratified the proposal of the directors that the financial plan be simplified by (among other things) consolidating the foregoing preferred issues into a new 7 per cent preferred stock. To accomplish this, the old stock was made exchangeable for the new preferred on the following terms:

1. One share of old 6 per cent preferred plus $10 to be exchanged for one share of new 7 per cent preferred.
2. One share of old 6 per cent debenture to be exchanged on the same basis.
3. One share of old 7 per cent preferred to be exchanged for new 7 per cent preferred on a share-for-share basis.

The extent to which the plan succeeded is revealed by a statement of the preferred stock outstanding at the close of 1924:

6 per cent preferred	$ 2,795,300
6 per cent debenture	4,869,900
7 per cent preferred (new)	102,250,800

In 1930, further simplification was effected by offering new no-par, $5.00 cumulative preferred stock in exchange for the three types outstanding; if the exchange was not made, the old stocks were called for redemption. Following this simplification, the financial plan consisted of only one class of preferred stock and one class of common stock for a

long period; but in 1946, new preferred stock was issued, and later long-term borrowing was used to meet the needs of the postwar period. Hence, it is to be expected in the years to come that consolidation of the financial pattern will continue as a normal and recurring incident.

REACHING THE INVESTORS MORE EFFECTIVELY

A corporation sometimes makes a minor recapitalization for the purpose of making its stocks more responsive to the needs of its security holders and to investors in general. If a stock is selling at a relatively high price, the market activity in the stock will be limited; and the price will be subject to rather wide fluctuation. To remedy this condition, the number of outstanding shares may be increased by resorting to a stock dividend or by simply splitting the shares. Under the first of these alternatives, a dividend is paid in stock; thus, in the case of a 200 per cent stock dividend, the holder of a single share would become the owner of three shares. The effect on the corporation would be to reduce the surplus and to increase the stock account by identical amounts.

When stock is split, there is no effect on the *amount* of either the surplus or stock accounts. If a stock were split 3 for 1, a stockholder would exchange one old share for three new shares. The market price of the stock would react accordingly and, on a strict, mathematical basis, would sell at one-third of the price at the time the exchange of stock became effective. Needless to say, a stock dividend would also affect the market price in accordance with the change in the number of shares outstanding. For example, if a stock were selling at $150 and a 100 per cent stock dividend were paid, the price should decline to $75 since there would be two shares for each share previously outstanding. Market responses, however, usually generate results that deviate from the arithmetic; consequently, the prices may reflect the attendant speculative influences.

How much the dilution of stock values is the result of speculative influence may not easily be appraised, but it is likely to have an indirect bearing. Moreover, a stock may need "news" to keep it before the public for reasons of psychology. Irrespective of dollar values, most people prefer to own 10 shares with a value of $70 per share than only one with the same total value of $700. Undoubtedly, consideration is given to this public preference in the evaluation of market levels on which corporations desire to have their stock sell. Also, the large amount of earnings per share which results from having fewer shares outstanding may be the cause of public misunderstanding and invite unnecessary attack. Consider, for example, the Eastman Kodak Company, whose stock reached a high of $800 in 1922. In order to bring the market price to a more convenient level, the company called in the old stock and issued 10 new shares of no-par stock for each old share of $100 par stock originally

held. In 1946, the no-par stock reached a high of 262 and, in May, 1947, there was a new split of 5 for one. In 1959, there was a further split of 2 for one, and the latest stock is currently selling at a price of 109⅜. Without the splits, the stock would now have a price on a mathematical basis of more than $10,000 per share; and the earnings per share for the latest fiscal year would have been about $323.[5] The range of public reaction to such large figures is quite apparent and shows the need for consideration of market responses as a matter of financial policy.

The policy of splitting stock or using stock dividends is seldom applied in times of depression but is fairly common in prosperity. Successful companies have occasion to resort to such practices at various times. For example, E. I. du Pont de Nemours and Company paid a stock dividend of 200 per cent in 1915, 50 per cent in 1922, and 40 per cent in 1925, and split its stock as follows: 2 for one in 1926, 3½ for one in 1929, and 4 for one in 1949. To indicate the possible effect of a stock split, it may be noted that the number of shareholders of du Pont increased from 92,753 at the end of 1949 to 108,774 at the close of 1950. Were it not for the dilution of the stock, the original shares would, on a mathematical basis, be currently selling at about $35,800; and the earnings per share in 1959 would have been $1,573.49.

Somewhat unique are the stock splits and stock dividends of the Brunswick-Balke-Collender Company. Well known as the largest manufacturer of bowling and billiard equipment and supplies, this company has engaged in a broad expansion program so that it now produces directly or through subsidiaries such items as the following: medical and hospital supplies, schoolroom furniture and gymnasium equipment, sporting goods, and components for aircraft and missiles. Cash dividends have been paid annually since 1937, and its record of stock dividends and splits for the period 1956–60 is as follows:

	Stock Dividend	*Stock Split*
1956	5%	—
1957	5%	2 for 1
1958	—	4 for 3
1959	—	3 for 1
1960	—	2 for 1

Occasionally, the splitting of stock is used to effect a major change in the life or pattern of a corporation. A dramatic example is found in the 1800 to 1 split of the stock of the Toledo, Peoria and Western Railroad when it reincorporated in 1953. Prior to the split there were two stockholders (the estate of George P. McNear holding 85 per cent of the

[5] The reported figures are not intended to give the precise mathematical effects; to achieve this result adjustments would also be required for stock dividends of 5 per cent paid in 1949, 1950, 1953, 1955 and 1957, as well as 10 per cent stock dividends paid in 1951 and 1952.

stock and the Hanover Bank of New York, 15 per cent), and the total stock outstanding consisted of 50 shares with a par value of $100. After the split, there were 90,000 shares with a stated value of $45 each.

Of much greater public significance is the transition of the Ford Motor Company from a closed to an open status in early 1956. Total shares of stock of all types were increased from 3,495,040 to 53,461,470. To visualize the use of stock splits to bring this about, we may note the following summary of the details:

I. Status of Ownership and Control before Split
   - B stock—172,645 shares, all held by Ford family interests, with 100 per cent voting control.
   - A stock—3,322,395 shares, of which 190,347 shares were held by Ford family interests; 42,140 shares by key employees; and 3,089,908 shares by the Ford Foundation. None of the A stock had the right to vote.

II. Details of Split and Interim Status
   - New B stock—3,625,545 shares to Ford family interests on basis of 21 for 1 split of old B stock, with voting rights retained.
   - New A stock—49,835,925 shares, without voting rights, distributed on 15 for 1 basis as follows: Ford family interests, 2,855,205 shares; key employees, 632,100 shares; and Ford Foundation, 46,348,620 shares.

III. Disposition of New A Stock
   - Holdings of Ford family—2,855,205 shares exchanged on share-for-share basis for new B common stock, making the total Ford family holdings of this stock, 6,480,750 shares.
   - Holdings of key employees—632,100 shares exchanged on share-for-share basis for new common stock (see discussion below for voting rights).
   - Holdings of Ford Foundation—39,396,327 shares retained and 6,952,293 shares exchanged on share-for-share basis for new common stock (see discussion below for voting rights) which, in turn, were sold to the public.

With respect to voting rights, the new B stock is entitled to 40 per cent of the total vote, while the new common is given the remaining 60 per cent. Furthermore, the B stock retains its voting position so long as there are 2,700,000 or more shares outstanding; if the shares are decreased to less than this number, their voting rights are reduced to 30 per cent of the total.

Probably the adoption of the plan is a recognition of the importance of public participation and support, and is one more instance of increasing awareness of the public interest. Yet the retention of control by Ford family interests is reminiscent of the practices pursued in the twenties—by legal device rather than sufficient investment. In summary, it may be observed that the Ford Foundation with 73.7 per cent of ownership of shares of all types has no voting rights; the key employees with 1.2 per cent and the public with 13.0 per cent ownership together have 60 per cent of the vote; while the Ford family with 12.1 ownership con-

trols 40 per cent of the vote, as previously indicated. As stated earlier, the motivation underlying the increase in the number of shares of stock is to prevent exorbitant earnings and prices per share of stock; also, active stock market conditions tend to create a financial style or enthusiasm for such actions. The latter may be seen in splitting stocks that are already in a price range not considered to be out of reach of the average investor. Under these conditions, investors can well afford to evaluate their significance and meaning.

REVERSE SPLITS

Occasionally, outstanding shares of stock are reduced by exchange for a smaller number; in the language of the "street," this is called a "reverse split." The thought is suggested that management may believe that the price of stock may be too low as well as too high. Not only is there a question of dignity but, also, there may be practical considerations—such as the convenience of having transactions in reasonable amounts.

Three examples of companies splitting their stock in reverse are the following:

General Motors Corporation. In 1924, one new share was issued for each four shares of old stock. In 1923, the latter had a price range of 12¾ to 17½; in the following year, the new stock ranged from a low of 55¾ to a high of 66⅞

Cities Service Company. During the twenties the stock of this company was in heavy demand and its price reached fantastic highs. However, in the thirties, there was the familiar cause for reckoning and opposite conditions prevailed. In 1938, ten shares of old stock were exchanged for one new share; until April, the month of the transition, the former had a price range of ¾ to 2⅛ and, during the rest of the year, the new stock ranged from a low of 5⅛ to a high of 11. As a sidelight, it may be noted that the company had 497,741 shareholders as of March 15, 1938, and 437,510 as of December 31, 1940.

Standard Brands, Incorporated. This company effected an exchange of one new share for each four shares of old stock in 1943. Until September, the month of the exchange, the latter had a price range of 4⅛ to 8; for the balance of the year, the new stock had a low of 27½ and a high of 33¾. At the close of 1942, there were 111,831 shareholders; 103,369 as of November 15, 1943; and 94,179 as of November 15, 1944.

In these days of prosperity, such transactions seem almost unreal; yet, as stated on other occasions, finance can be a hard taskmaster. Will history repeat itself? Or, have we overcome the threat of serious depression? In any event, we may be sure that change in some form will make its appearance in the days to come.

PURCHASE AND SALE OF EXISTING SECURITIES

Minor changes in the character of the capitalization may be effected by either purchase or sale of the existing securities. While neither may

necessarily be the cause of changing the amount of the reported capitalization, such transactions may influence its basic nature. For example, a corporation may buy its own bonds in the market and hold them as an asset in its treasury; yet, for all practical purposes, they are retired almost as effectively as if they were called for redemption. The same is true of the purchase of preferred and common stock. Conversely, the sale of existing holdings, either by the corporation or by outside interests owning large blocks of securities, may change the basic nature of the plan of financing.

The retirement of preferred stock by purchase in the open market, or by bids for this express purpose, is a fairly common transaction. For example, in 1950, the Abitibi Power and Paper Company, Ltd., purchased and retired its own preferred stock in the amount of $4,827,600; as a result, the dividends on this issue were reduced from $2,054,105 in 1949 to $1,730,406 in 1950. Simultaneously, there occurred a change in the source of funds and in the cost of obtaining money which necessarily affected the position of the common stock in corresponding measure.

More spectacular is the action of Colt's Manufacturing Company in 1950 in reducing its stock and surplus by almost 50 per cent as a result of buying its own stock. The effect may be seen in the analysis of the company's capital structure (Table 20).[6] To note a few items of corol-

TABLE 20

CHANGES IN CAPITAL STRUCTURE OF COLT'S MANUFACTURING COMPANY

Item	December 31, 1950	December 31, 1949
Capital stock (par $25)	$ 5,000,000	$ 5,000,000
Surplus	8,818,950	8,282,223
Total net worth	$13,818,950	$13,282,223
Less: Reacquired stock at cost	6,653,174	109,174
Net stock and surplus	$ 7,165,776	$13,173,049
Number of shares outstanding	71,073	195,900
Book value per share	$100.82	$67.24
Earnings per share	$ 13.28	$ 2.65

lary interest, it may be observed that no dividends were paid on the stock in 1948, following which they were paid at the rate of $5.00 per share from 1950 to 1952. In 1953, the stock was split 5 for 1, and dividends for that year were the equivalent of the previous rate; in 1954, quarterly dividends amounted to $0.85 per share. Operations for the first 20 weeks of 1955 resulted in a deficit; later, the company became a subsidiary of the Penn-Texas Corporation and its name was changed to its original title when incorporated—Colt's Patent Firearms Manufacturing Company.

[6] *Moody's Industrials*, March 28, 1951, sec. 1, pp. 1343–44.

When corporations buy or sell their own stock, the amount of capitalization is necessarily affected; but this is not true when the transactions are effected by parties other than the corporation. However, on the basis of motive and intent, there may be a change in the character of the financial plan. To illustrate, holders of a large block of stock in the Moore-Handley Hardware Company sold 85,000 shares in 1947 at $7.50 per share and 350,000 shares at $9.00 per share in 1949. The sales were made by a public offering and did not represent new financing by the company. Since only 500,000 shares of stock were outstanding as of the close of 1949, it is apparent that a basic change in ownership was accomplished.

The sale of existing securities by means of public offerings, either by private holders or corporations, is not large in volume. In the fiscal year ended June 30, 1959, offerings of this type registered with the Securities and Exchange Commission for cash sale amounted to $703,284,000, of which common stock accounted for $678,160,000.[7] At the same time they reflect an interesting feature of corporation finance since they usually constitute a means of transition from limited private to broader public ownership. At times, such offerings permit the orderly liquidation of estates without unduly disturbing the market; at other times, they may provide a convenient medium which permits the earlier private owners to realize sizable profits without losing basic control of the enterprise.

LEGAL REASONS FOR CHANGES IN CAPITALIZATION

On some occasions, changes in capitalization may be compelled by virtue of legal requirement. Such change is inevitable in the case of failure and reorganization, but it is also possible for perfectly solvent corporations to be affected by abrupt or unusual changes in legal status. The most outstanding example in recent times is found in the Public Utility Holding Company Act, which is discussed at length in a later chapter. However, at this point it may be observed that the act compels the dissolution of numerous companies holding stock in others and the rearrangement of existing public-utility systems. When the process is completed, considerable revamping of the capital structure of the remaining companies will be inevitable. Somewhat comparable is the effect on railroads of the so-called "commodities clause" of the Hepburn Act,[8] which was passed in 1906. In brief, it provided that railroads could not haul in interstate or foreign trade any commodities, other than timber and its related products, which railroads themselves "manufactured, mined or produced. . . ." The net effect, of course, was to force the railroads to

---

[7] Securities and Exchange Commission, *Twenty-fifth Annual Report for the Fiscal Year Ended June 30, 1959*, p. 217.

[8] United States Statutes at Large, 59th Cong., Vol. 34, Part I, p. 585.

divest themselves of such activities, which, in turn, affected their financial arrangement.

Along similar lines, the financial pattern of operating public-utility companies and of railroads may be affected indirectly by regulation. This is achieved by virtue of the power of the regulatory bodies to approve new security issues. In so doing, it is not unusual to find various conditions imposed which affect the entire capital structure.

At other times, the change in capitalization as a result of legal influence may be purely voluntary on the part of corporate management itself. For instance, it may prove advisable to change the state of incorporation for the purpose of obtaining rights or powers not possible in the original state. Whenever a corporation does shift in this manner, the effect upon the capitalization is usually of a minor nature. For the most part, it consists simply of the exchange of securities of the new corporation for similar ones of the old corporation.

Another condition which occasionally causes a corporation to shift from one state to another is the taxes imposed by the states concerned. At a previous point, the importance of taxation in connection with the original incorporation of a company was discussed; and the application of the problem is somewhat similar here. The stimulus responsible for the reincorporation may possibly be caused by a change in tax rates or by an event that may not have been anticipated at the time of the initial capitalization.

The growth of a corporation may also make it desirable to select another state. The domestic state may offer sufficient powers for the purposes of the original limited operations but may prove entirely inadequate for the extended activities. While this case is not representative solely of legal peculiarities, the process of recapitalization is affected by the legal potentialities offered by the various states.

RECOGNIZING CHANGES IN THE VALUE OF ASSETS

In the revaluation of corporate assets, it is possible to recognize either appreciation or depreciation. Conservative accounting practice seldom sanctions the former but is favorably inclined toward the latter. In either event, the financial plan is affected by the process. An illustrative case is that of the United States Industrial Alcohol Company. Early in 1933, the stockholders approved the virtual writing-off of the "land, buildings, and equipment" account by voting to carry the account at the nominal value of $1.00 in place of the previous valuation of $19,301,045. To absorb the charge, a small amount was debited to earned surplus and the balance to capital surplus. The capital surplus had been created especially for this purpose by lowering the book value of the capital stock from $22,584,600 to $3,738,460. The announced purpose of the

adjustment was to reduce fixed charges and to correct an overdeveloped capitalization.

The chief effect of such value adjustments is to eliminate depreciation charges and to introduce in their place a smaller charge for renewals and replacements whenever made. Because of this reduction in annual operating expenses, it is possible to show a higher operating return. Actually, no change of any fundamental importance is made; and any dividends paid thereafter require careful analysis to determine whether or not they are in fact being paid out of capital. In 1941, the company restored the book value of the fixed assets to a depreciated cost basis; and in 1943, it was merged into its wholly owned subsidiary, the United States Industrial Chemicals, Inc.

A more common practice is to write off the value of good will and other intangible values. For example, the P. Lorillard Company chose, in 1933, to report the value of its "brands, trade-marks, good-will, etc." at $1.00, in comparison with the figure of $21,268,339 previously carried. This necessitated reducing the common stock from $44,519,255 at the close of 1932 to $18,878,620 the following year. In 1950, the American Tobacco Company reduced its good-will account from $54,099,431 to $1.00. But, in this instance, the charge was made to the surplus account; and the stated amount of the stock was not affected.

In the preceding cases, no attempt is made to determine the current value of the property accounts; and their value is reduced to a nominal figure primarily to be conservative. Another basis of action is to have an appraisal of the property. The Pure Oil Company has resorted to this practice on at least two occasions, recognizing an appreciation of value in 1917 and a decrease in 1932. In the first instance, the adjustment was made by setting up a capital surplus account amounting to $39,540,621. In the latter year, the property account was written down by approximately $70,000,000. Thus, not only was the capital surplus item eliminated, but in addition the common stock figure was also necessarily adjusted.

In terms of book figures, the foregoing illustrations reflect major transitions in the capital structure. They also indicate the artificial nature of the bookkeeping processes. When the property account is reduced to a nominal or an appraised figure, it should be clear that existing values are not changed in any sense; and, similarly, earning power is not affected. Likewise, the market value of the stock is seldom affected by the change. The question may therefore be raised as to the significance of this form of recapitalization. No general rule can be stated because each case calls for special analysis. On occasion, the adjustment may be a legitimate revaluation to bring book values in line with estimated prevailing values. On other occasions, it may be a financial adjustment to make possible the showing of earnings and the paying of dividends. However,

such actions may well be scrutinized for evidence of temporizing on the part of management without support of basic, financial principle.

ELIMINATION OF A DEFICIT

Most of the capital adjustments discussed up to this point are opportunistic in character and are seldom the result of any particular urgency or pressure. Attention may now be given to those cases where there is some degree of compulsion short of actual failure. Usually, there is need to eliminate a deficit or accumulated preferred dividends, or both. Even though a corporation may continue to function with a deficit, it is generally desirable to make provision for its elimination by capital adjustment whenever there is little prospect of wiping it out in fairly short order with earnings. Otherwise, its existence prevents the payment of dividends and impairs the financial standing of the corporation. It has all the qualities of a "red flag" which reminds the public of a none-too-favorable record in the past.

Actually, the wiping-out of a deficit effects no change in the value of the assets and is largely a bookkeeping transaction. Yet, from a legal point of view, the "decks are cleared" by the approval given by the stockholders; and the corporation is enabled to proceed normally. For example, a corporation may have incurred a large deficit during some unfavorable period of operation; but the current operations are profitable. Earnings are now satisfactory, the working capital position is sound, and funds are available to pay dividends. Under these circumstances, both common sense and financial policy suggest that the stated value of the stock be reduced in order to wipe out a deficit that is no longer relevant.

A case in point is the General Steel Castings Corporation, which lost money each year from 1935 to 1939. The accumulated deficit amounted to $14,640,537 at the close of the latter year. During 1940, the stated value of the common stock was reduced from $13,772,430 to $456,756; and the difference, together with certain reserves, was used to eliminate the deficit. Needless to say, the capital adjustment could have no effect upon the physical operations; but it may be observed that the deficit would have continued for more than seven years were it not for the recapitalization. In 1950, the company increased its common stock from $456,756 to $11,414,000 by transfers from surplus, after which it still had a balance of $10,388,820 in the latter account. But the financial scene is ever changing; as of December 31, 1959, common stock, with a par value of $1.00 per share, amounted to only $813,345, as compared with capital surplus of $13,325,542 and earned surplus of $19,321,502.

ELIMINATING ACCUMULATED PREFERRED DIVIDENDS

The innumerable cases of recapitalization for the purpose of wiping out accumulated preferred dividends give mute testimony to the possible

unhappy lot of the holders of such stock. No law exists to compel the payment of the arrearages; and management, along with the common stockholders, has the whip hand in constraining an adjustment. Legal proceedings may be instituted to challenge the equity of proposed settlements, but the burden of expense and the continued absence of dividends discourage such action.

As may be gathered from the earlier discussion of preferred stock in Chapter 6, it has many of the characteristics of a "compromise" security. Often, in the case of a new company, it represents the bulk of the cash investment, the common stock being used to cover promotion and organization expenses. It is also used frequently in the reorganization of companies in failure, being issued in exchange for the claims of junior bondholders; similarly, it may be exchanged for other preferred stock on some modified or step-down basis as to dividend rate and the amount of principal. Because of the optional character of dividends, preferred stock seems to function as a convenient stopgap and lends itself to recapitalization. Indeed, the capital revisions may assume a sort of serial status, their recurrence being dependent upon company and business conditions, as may be seen in the following:

The Childs Company.[9] No dividends were paid on the 7 per cent cumulative preferred stock of the Childs Company from October 10, 1931, until a plan of recapitalization was effected in 1948. Accumulated dividends as of February 28, 1947, amounted to $106.17 per share. Under the settlement, each share of old preferred stock received one share of new 5½ per cent cumulative preferred stock and 12 shares of new $1.00 par common stock in exchange for all claims against the company. Dividends were then paid on the new preferred stock until March 31, 1949, when they were again discontinued. Accumulated dividends per share as of December 31, 1950, amounted to $9.63. In 1951, another recapitalization was effected in which each old share of $100 par 5½ per cent preferred and the accrued dividends were exchanged for 4.4 shares of new convertible 5 per cent preferred stock with a par value of $25. Dividends on this last issue did not commence until March 31, 1958, but the accumulations were paid in 1959 and the dividends are now on a current basis.

Armour and Company (Illinois). As of the close of the fiscal year 1933, the capitalization of Armour and Company (Illinois) consisted of the following: funded debt, $89,841,000; 7 per cent cumulative preferred stock, $57,231,300; Class A common stock, $50,000,000; and Class B common stock, $50,000,000. As early as 1927, the company was unable to pay any dividends on the Class A stock; and, in 1931, only $1.75 was paid on the preferred stock. It again failed to pay the preferred dividends in 1932 and 1933; and, in 1934, a recapitalization was approved that provided for an exchange of securities as follows:

7 Per Cent Preferred Stock. Offered one share of new 6 per cent cumulative convertible prior preferred for each share of 7 per cent stock, and 2 shares of new common stock for the accumulated dividends.

Class A Common Stock. Exchanged share for share for the new common stock.

Class B Common Stock. Received one-half share of new common stock for each share of old B stock.

As a result of this plan, the A and B common stocks were eliminated; but

[9] See p. 270 for change of name.

some 33,715 shares of the old preferred remained outstanding as of the close of 1946. Indeed, as of April 15, 1947, arrearages on this stock had again appeared in the amount of $64.75 per share, while $15 had accumulated on the 6 per cent cumulative convertible prior preferred.

A revision of the capital structure was approved again in July, 1946. New no-par first-preference stock was to be offered to the holders of the old 6 per cent prior preferred in a ratio of 1.4 to one, and new no-par convertible second-preference stock was to be sold to the public. In addition, the old common stockholders were to be offered one-third of a share of new common for each share of old. Certain amendments were made in the plan in the following December; but more satisfactory earnings, combined with favorable prospects, caused further delay in the execution of the plan. Eventually, in July, 1947, the company sold $35,000,000 of 25-year cumulative income debenture 3½'s (subordinated) to a group of insurance companies; and the proceeds, along with approximately $3,000,000 obtained from the general working fund, were used as follows:[10]

To retire a temporary issue of previous subordinated debentures	$20,993,500
To redeem 33,715 shares of 7 per cent cumulative preferred stock and accumulated dividends	6,178,273
To liquidate the unpaid and accumulated dividends on the 6 per cent prior preferred stock	7,994,940
To reduce the number of 6 per cent prior preferred shares from 532,996 to 500,000	Balance

The reader may ask what is the difference, if any, between income debentures and preferred stock, particularly when the debentures are "subordinated to all other debt at any time outstanding (except debt to subsidiaries)"; and the answer is likely that there may be little of any consequence.[11] Also, only the future course of events can determine whether a permanent solution has been effected—or whether once again there will be need for further recapitalization.

SUMMARY OF CHANGES IN CAPITALIZATION

It has been shown that the capitalization of a corporation is the medium by which funds are provided to meet the needs of its long-term financial program. Not only is it essential that a sufficient amount of capital be made available, but it is equally important that the supply synchronize with changing conditions. It is possible to have either too much or too little capital. The former may give to management a sense of freedom and independence; but, at the same time, a persistent redundance can prove to be a drain on income and a source of embarrassment. On the other hand, a shortage of capital may prevent the adoption of promising opportunities and, at times, be a contributing cause of failure.

The essence of sound administration of the capital structure is, therefore, to be found in effecting a balance that is intended to accommodate the changing needs of business operation. This balanced position means

[10] *Moody's Industrials*, July 23, 1947, p. 2697.

[11] However, see pp. 174–75 for difference in treatment of dividends and interest for tax purposes.

not only that the capitalization should harmonize with the asset structure, but in addition it means proper arrangement of the various securities or means which are used as a source of capital supply. Excessive funded debt can lead to ruinous fixed charges which result in failure; hence, it is exceedingly important that the capitalization be sufficiently flexible to permit revision. Both bonds and preferred stock should, wherever possible, contain the call feature, so that management can have the necessary freedom to effect rearrangement. Common stock and surplus, by virtue of their residual position, are more readily adjusted and may even be reduced drastically without resulting in failure.

Despite the long-term function of capitalization, it is apparent that it is, nevertheless, changed at irregular intervals. Changes may occur automatically, such as those found in the exchange of convertible bonds for common stock; or revisions may be planned deliberately to meet specific needs. The latter are more typical of financial activity and are of the type described in this chapter. All too often, however, these changes are haphazard or are the result of pressing emergency. This is caused by the tendency to continue with the *status quo* as long as possible instead of using capitalization as a tool or moderator of business action. It is in this latter respect that the capital structure may serve as an important means of keeping an institution on even keel. Skilled management will anticipate needs by careful planning; less capable management too often waits for something to happen and then proceeds with abrupt adjustment.

QUESTIONS AND PROBLEMS

1. Evaluate the influence of planned business expansion upon: (*a*) The amount of capitalization. (*b*) The composition of the capitalization.
2. Discuss the merits of providing for a modification of indentures (*a*) from the management's point of view and (*b*) from the investors' point of view.
3. Review the early recapitalization of the United States Steel Corporation described on page 234, and discuss the following questions: (*a*) Do you think it was sound policy to issue additional bonds? (*b*) Do you think that the interlocking of directors between the corporation and the syndicate was proper? (*c*) Do you think that the court opinion was based upon technical or substantive reasoning?
4. Study the sources and uses of corporate funds for the period 1956–59 as shown by the *Survey of Current Business* (U.S. Department of Commerce, October, 1960, p. 17) and state your opinion on the following: (*a*) The nature and importance of depreciation as a source of funds. (*b*) The nature and importance of retained profits as a source of funds. (*c*) The nature and importance of securities as a source of funds.
5. Refer to Table 16 on page 219, and discuss the relative importance of surplus in the three fields of industrials, public utilities and railroads.
6. Discuss the importance of the right of redemption as a factor that facilitates changes in capitalization. Also evaluate the position of the investor.
7. Summarize the arguments against the substitution of a senior for a junior security. Under what conditions would you recommend it?

8. Comment on the following features of financing by the Reading Tube Corporation: (*a*) Issuance in 1951 of 20-year 6 per cent debentures (retired in 1956 at 103) and Class B stock in exchange for the old Class A stock, each share of the latter receiving $7.00 principal value of debentures and one fourth of a share of B stock. (*b*) Issuance in 1959 of $5,000,000 sinking fund debenture 5¾'s, due in 1974, and accompanying warrants which permit the purchase of 35 shares of common stock (for each $1,000 bond) at a price of $11.00 per share until July 15, 1964. The units of debentures and warrants were sold at a price of $1,000 each, and the main purpose of the new funds was to retire bank loans of $3,050,000.
9. In 1955, the Brown Company issued 4½ per cent sinking fund debentures, due in 1975, and one share of common stock in exchange for each share of first preference stock with a dividend rate of $5.00. Discuss the merits of this exchange.
10. Evaluate the significance of the practice of splitting stock, and comment on the record of the General Motors Corporation in this respect.
11. Refer to page 237, and discuss the reasons for the recent annual splitting of stock by the Brunswick-Balke-Collender Company.
12. Until 1959, the American Telephone and Telegraph Company consistently avoided the splitting of its stock and, despite its comparatively high price, had the largest number of stockholders of any corporation in the world. (*a*) How do you account for the large number of stockholders? (*b*) Discuss the reasons for changing the policy.
13. For the period 1950–59, inclusive, some 481 stocks listed on the New York Stock Exchange were split 2-for-1 or more (see *The Exchange*, January, 1960, p. 9). Evaluate the factors contributing to this record, and consider the motivations of management from a financial point of view.
14. Do you think that preferred stockholders are morally entitled to 100 per cent payment of accumulated dividends before anything is paid on the common stock?
15. "Financial plans become complex to get a company out of business difficulty, only to establish a basis for future trouble." Explain and evaluate the merits of this statement.
16. What is meant by the statement that debentures are "subordinated to all other debt"? As an investor, would you purchase such a security?
17. Discuss the points that are involved in the purchase of its own stock by Colt's Manufacturing Company, as set forth on page 240.
18. In 1960, the Lockheed Aircraft Corporation elected to write off some $24,500,000 of costs or losses sustained in the modification of its jet-prop planes. Other costs for the development of jet transports were similarly absorbed. The chairman of the board of directors indicated that by "getting the costs and losses behind us, we make it possible to realize a profit on future sales . . ." Discuss the nature and soundness of this policy.

REFERENCES

Barker, C. Austin. "Effective Stock Splits," *Harvard Business Review*, Vol. XXXIV, No. 1 (January–February, 1956), pp. 101–6.

Bradley, Joseph F. *Fundamentals of Corporation Finance*, chap. xxx. New York: Rinehart & Co., Inc., 1959.

Freund, William C. "An Appraisal of the Sources and Uses of Funds: Ap-

proach to the Analysis of Financial Markets," *The Journal of Finance*, Vol. XIII, No. 2 (May, 1958), pp. 275–94.

FUNSTON, KEITH, President of the New York Stock Exchange. "Corporate Capital Needs between Now and 1965," *Commercial and Financial Chronicle*, Vol. 181, No. 5442 (June 30, 1955), pp. 3, 20–21.

HUBBARD, PHILLIP M., JR. "Short-Term Market Impact of Secondary Distributions," *Commercial and Financial Chronicle*, Vol. 191, No. 5946 (April 28, 1960), pp. 11, 30–31.

MATTHEWS, JOHN B., JR. "How to Administer Capital Spending," *Harvard Business Review*, Vol. XXXVII, No. 2 (March–April, 1959), pp. 87–99.

MCLEAN, JOHN G. "How to Evaluate New Capital Investments," *Harvard Business Review*, Vol. XXXVI, No. 6 (November–December, 1958), pp. 59–69.

REIERSON, ROY L. "The Changing Capital Markets," *The Journal of Finance*, Vol. XV, No. 2 (May, 1960), pp. 289–98.

RIPLEY, W. Z. *Trusts, Pools, and Corporations*. Boston: Ginn & Co., 1916.

Chapter 14 ►

THE OWNERSHIP OF CORPORATIONS

THREE PILLARS of the modern corporation are its capitalization, the nature of its ownership, and the character and capacity of its management. In pursuance of our successive analyses of each of these corporate supports, attention will be given in this chapter to ownership. With its qualities of an ultimate and residual right, ownership may have varying degrees of firmness. Strong or weak, enthusiastic or indifferent, vigorous or apathetic—these simply suggest the possible moods or attitudes of owners. Particularly are these alternative characteristics applicable to stock ownership of the large corporation where the dimensions make personal contact virtually impossible. Indeed, for corporate purposes, the stockholders exist mainly as a group, not as individuals. At the same time, the corporation can ill afford to lose the support and good will of its owners.

OWNERSHIP IN THE LIGHT OF BUSINESS DEVELOPMENT

Once motivated by a sense of personal belonging and ownership, the corporation is now in many respects an institution in its own right—the product of momentous business development and of social and economic pressures. As one authority has said, "The individual shareholder now has largely a 'pig-in-a-poke' . . . and . . . his old vested rights are gone or are going."[1] But the opinion is expressed that the "development has been a necessary one" and that our system of business organization must be adequate to meet economic demands. Furthermore, there can be little doubt about the conclusion that the welfare of the corporation as a whole is paramount to that of the single shareholder.

The problems of the small corporation are quite different from those of the large organization; but under the existing pattern, both are gov-

---

[1] W. B. Rutledge, Jr., "Significant Trends in Modern Corporation Statutes," *Washington University Law Quarterly*, Vol. XXII (April, 1937), p. 337.

erned by the same laws and engage in many of the same formalities. The idea of a corporation, created to handle even personal matters, taking a formal vote and acting with all the decorum of a large institution is quite preposterous, but it is nonetheless a legal requirement. Eventually, we may develop different statutes which would apply according to the size and character of a corporation; but seemingly there is little prospect at the moment of approaching corporate problems in this manner. Hence, our comments with respect to ownership will be addressed mainly to the large corporation; but the reader may wish to think of their application to smaller units.

RESPONSIBLE TO WHOM?

One of the most challenging issues of our day is that of the responsibility of the corporation. To whom does it owe its accounting or its stewardship? Legally and nominally, it is well established that the basic obligation is toward the stockholders. "On the other hand, the idea that fifty thousand investors can express an intelligent opinion about the conduct of corporate affairs in a changing business world characterized by a rapidly fluctuating price structure is an absurdity except for the rarest instances of emergency action."[2] As a result, the very life of the corporation is almost totally dependent upon the delegation of power to management. From this, there can be little escape—whether the corporation be large or small.

Once power is delegated, whether it be in government or in private business, the holders of the authority then have a tendency to assume that they are the "beginning and the end." There follows a weakening of the sense of responsibility *to others*, which alone can provide enduring strength and ultimate soundness. Dependence upon a single individual or a small group is both enervating and dangerous in the long run. It is because of these conditions that corporate leaders may well give serious thought to the question of their obligation, because they must be responsible to some external body.

Overdevelopment of the sense of responsibility to society at large can only lead to unnecessary regulation by the government with all its restraint and interference. The alternative is to enlarge and to accentuate the obligation to the stockholders as a group. Despite their lack of sharp identity and despite their inability to act in an effective manner, it is likely that satisfaction of their needs will automatically be transferred to the public as a whole. This does not mean that management will simply try to earn the largest return on the investment of the stockholders but rather that attention will be given to all elements of their welfare. Indeed, to carry out the duties of the latter there may be need to protect the larger

[2] *Ibid.*, p. 329.

area of operations in order to bolster the stability of the specific institution. Seen in this broader light, management should more and more assume the full stature of trusteeship.

NATURE AND CLASSIFICATION OF OWNERSHIP

Consistent with the broad pattern of the national economic structure, there is a wide variety of corporate ownership—individual and institutional, real and beneficial, speculative and investment, and other miscellaneous categories. Although these terms are largely self-explanatory, it may be helpful to expand the basic concepts by summary discussion.

Individual and Institutional Ownership. Individual or personal ownership may be established on a single or joint basis according to the laws of the states in which the holders are resident. In most operating companies, individual ownership accounts for a very large percentage of the total *number of holders*, but does not necessarily hold a similar position with respect to the *holdings of shares*. In recent years, institutional holders of various types—investment trusts, pension funds, fiduciaries, insurance companies and other miscellaneous forms—have increased notably in their economic position, and have become important factors in stock ownership. By the end of 1959, it is estimated that stockholders of the institutional type held more than 20 per cent of all common and preferred stocks.[8]

Purely aside from their financial position, individual stockholders are held in particularly high esteem as a means of promoting public following and support. For this reason, both corporations and the stock exchanges constantly strive to increase ownership by individuals. Various educational programs have been developed by the New York Stock Exchange and, in addition, its member firms have tried to increase stock ownership by means of a Monthly Investment Plan—conveniently designated as MIP. Investments may be made regularly by individuals acting on their own account, but the more common arrangement takes the form of a so-called "investment club." As of November, 1959, there were 20,100 identified clubs with holdings having an aggregate market value of $160,000,000; new investments were being made at the rate of $5,130,000 per month. The informal nature of these clubs is indicated by their size—92.3 per cent of the total had twenty members or less. Only 7 per cent were organized as corporations, while the remainder functioned as partnerships or joint ventures. In essence, the clubs combine neighborly or friendly relations for the purpose of making investments, each member putting up an amount—often $10.00—at each monthly meeting. The pooled amount is then invested in common stocks selected by the mem-

---

[8] See Table 21 on page 254.

bers. The plan is generally noncontractual which means that there is no penalty for failure to make the scheduled payments.[4]

Real and Beneficial Ownership. Stocks may be held outright in the name of the real owner in fact, or they may be held in a beneficial capacity. Illustrative of the former are both individual and corporate holdings of stock held in their own names. The latter may best be explained by discussion and example. Generally speaking, the holding of a stock in a beneficial capacity implies a trust relationship—either express or constructive. An express trust is a formally created legal arrangement in which a trustee is designated to serve in behalf of the trustors or beneficiaries. The title would reside in the trustee on behalf of the beneficial owner, but the income and other benefits would extend to the latter. Many of the holdings of fiduciaries would be of this nature.

A constructive trust is one that is not expressly created, but rather is deemed to arise out of the nature of the practical, working arrangements. For example, the purchaser of stocks may elect not to have them titled in his own name and, instead, he acquires the right to stock that is carried in so-called "street" names. When this is done, the broker serves, in effect, as a trustee; and while there is no formal trust agreement, there are present all of the elements of an implied or constructive trust. The broker, of course, stands ready to deliver stock in the name of the true owner at any time upon request. Since a large volume of stock trading is for speculative purposes, it is not surprising that a considerable amount of stock is held on a "street" or "nominee" basis.

Speculative and Investment Ownership. In addition to the substantive nature and title of ownership, brief reference should also be made to its motivation. For the most part, the major difference from this point of view is whether stocks are held for speculative or investment purposes. Granted that a sharp line may not be drawn between speculation and investment, there is common recognition of the difference between stocks held for quick gains and those held for long-term benefits. Increasingly, corporations are cultivating the interest of holders of stock of the latter type but they can by no means ignore the former; indeed, speculators can play a prominent part in molding public opinion with respect to the securities of any corporation. However, the sustained interest and following of long-term holders of stock have much greater significance as a result of numerous trends in our modern society. More than ever, it is necessary for corporations to have good public standing in order to protect themselves against adverse legislation as well as to create an atmosphere favorable to the sale of their products and services.

---

[4] See "20,000 Investment Clubs," *The Exchange*, March, 1960, pp. 12–16. Also, it should be noted that the statistics cover only those clubs which have accounts with some 500 members of the New York Stock Exchange.

THE OVER-ALL OWNERSHIP PICTURE

To visualize the relative standing of the various categories of stock ownership, we may note the findings reported in Table 21. The coverage embraces estimates for more than 5,000 public corporations scattered throughout the United States, and also shows aggregate data for foreign holdings. Comparison of the two years reported gives evidence of a trend

TABLE 21

CLASSIFICATION OF COMMON AND PREFERRED STOCKHOLDERS AND SHAREHOLDINGS, 1959 AND 1956*

Classification	Stockholders of Record				Shareholdings			
	Number (In Thousands)		Percentage of Total		Number (In Millions)		Percentage of Total	
	1959	1956	1959	1956	1959	1956	1959	1956
Total	37,987	31,237	100.0	100.0	10,206	7,913	100.0	100.0
Foreign	912	812	2.4	2.6	606	281	5.9	3.6
Domestic	37,075	30,425	97.6	97.4	9,600	7,632	94.1	96.4
Males	12,322	10,612	32.4	34.0	2,316	2,100	22.7	26.5
Females	14,249	12,050	37.5	38.6	2,013	1,710	19.7	21.6
Joint Accounts	7,289	5,120	19.2	16.4	730	533	7.2	6.7
Fiduciary Individuals	1,221	959	3.2	3.1	437	305	4.3	3.9
Fiduciary Institutions	497	497	1.3	1.6	256	263	2.5	3.3
Brokers and Dealers	424	355	1.1	1.1	815	708	8.0	8.9
Nominees	347	256	1.0	0.8	1,247	772	12.2	9.8
Institutions and Others	726	576	1.9	1.8	1,786	1,241	17.5	15.7

* *Share Ownership in America: 1959* (New York, N.Y.: New York Stock Exchange), pp. 33, 34.

that has likely been in the making for a considerable period of time—increased prominence of holdings by agencies of the institutional type. Also reflected is the possible transitory nature of some holdings, particularly those in the names of nominees and brokers and dealers.

TRENDS IN OWNERSHIP

Next we may observe the trends in the number of stockholders of corporations selected from the three major fields of enterprise. These will necessarily reflect the influence of corporate performance over the years as well as changes in general economic conditions; also present, but immeasurable, will be the underlying drift of changing economic and social attitudes. Table 22 shows the number of stockholders of the indicated corporations for various years from 1910 to 1959. It will be observed that the changes during the past half-century are often dramatic; but, at the same time, there are clear indications of the changing public status of the three fields of enterprise. Despite the variations, the picture shows that stock ownership has become a more or less commonplace practice for many people; but, in recent years, it has become increasingly selective.

The companies shown in Table 22 are representative of old, long-

standing corporations whose existence dates to 1901 or earlier; and it is interesting to observe that they are still among the leaders. In the meantime, many other companies of prominence have developed and are playing an active part in the business world. Their record in comparison with selected railroads of long standing may be seen in Table 23. While no valid generalizations may be drawn from such a limited number of companies, the changes in position may be suggestive of trends and other meanings. First, it would appear that railroads may be losing ground in their comparative standing. Second, the gains made by the reported indus-

TABLE 22

NUMBER OF STOCKHOLDERS OF SELECTED CORPORATIONS, 1910–1959*

Company	Number of Stockholders				
	1910	1928	1940	1954	1959
Industrials:					
American Car and Foundry Co.	9,912†	17,152†	8,792	8,100	14,108
American Smelting and Refining Co.	9,464†	6,000	21,462	28,049	27,311
E. I. du Pont de Nemours and Co.	2,050†	9,970	63,467	133,997	202,069
General Electric Co.	9,486	51,882	215,556	295,945	417,054
Standard Oil Co. of New Jersey	5,847	62,317	136,355	297,000	591,179
United States Steel Corp.	28,850	102,905	163,425	221,896	268,247
Public utilities:					
American Telephone and Telegraph Co.	40,381	454,596	630,902	1,307,215	1,754,200
Commonwealth Edison Co.	1,780	40,000	100,100	132,829	149,500
Western Union Telegraph Co.	12,731	26,234	28,525	19,410	38,274
Railroads:					
Chesapeake and Ohio Railway Co.	2,268†	6,885†	50,877	88,122	89,857
Illinois Central Railroad	9,790†	21,147†	13,688	7,707	11,458
Pennsylvania Railroad Co.	65,283	157,650	205,883	154,398	125,615
Union Pacific Railroad Co.	20,282	47,932	50,131	58,325	87,705†

* 1910–28, G. C. Means in *Quarterly Journal of Economics*, Vol. XLIV (1930), p. 594; and *Moody's Manuals*.
† Includes preferred stockholders.

trials and public utilities, particularly since 1950, may not appear as impressive as earlier increases; undoubtedly this is caused in part by increased institutional ownership which naturally limits the number of owners of record. Third, there has been diversion of ownership to newly organized and rapidly growing companies in the electronics and other technological fields. For illustration, we may note the number of common stockholders of such companies as the following (as of late 1959 or early 1960): International Business Machines Corporation, 113,183; Thiokol Chemical Corporation, 17,700; and Texas Instruments, Inc., 16,000.

TABLE 23

NUMBER OF STOCKHOLDERS OF SELECTED CORPORATIONS, 1929–59*

Company	Number of Stockholders				
	1929	1940	1950	1954	1959
Industrials:					
General Foods Corp.	24,208	65,114	63,815	61,100	63,252
National Dairy Products Co., Inc.	28,652	69,264	64,420	63,177	70,041
Radio Corp. of America	50,000	227,138	173,680	160,202	153,600
Sears, Roebuck & Co.	18,222	55,011	94,362	96,834	152,623
Public utilities:					
Commonwealth and Southern Co.	38,000	163,561	80,555†	122,838†	124,454†
Detroit Edison Co.	13,726	14,921	54,958	75,516	105,936
Pacific Gas and Electric Co.	24,015	96,122	93,742	129,077	140,170
Railroads:					
Baltimore and Ohio Railroad	34,783	38,397	15,244	11,909	11,579
Erie Railroad	6,297	5,185	18,973	17,945	17,216
New York Central Railroad	52,690	62,345	49,577	39,815	34,814
Santa Fe Railway	40,927	34,085	39,046	39,706	74,100

* 1929, direct correspondence with individual companies; other years, *Moody's Manuals.*
† Stockholders of the Southern Company, successor to Commonwealth and Southern Company, which was dissolved pursuant to integration and simplification program required by Public Utility Holding Company Act.

FURTHER ANALYSIS OF SHARE OWNERSHIP

To get an accurate picture of participation by the public in corporate ownership, we should distinguish sharply between the aggregate shareholders of record and the total number of separate entities owning stock. Many people own the stock of more than one corporation and, for this reason, will obviously be multiple owners of record. As shown in Table 21, it is estimated that there are some 37,075,000 domestic owners of record, of which 35,081,000 represent individual as distinguished from institutional owners (fiduciary institution, brokers and dealers, etc.). After allowing for the duplication caused by multiple ownership, it is estimated that 12,490,000 different people own the shares of the more than 5,000 public corporations embraced in the census made by the New York Stock Exchange.[5]

Another qualitative feature of stock ownership is found in the comparative diffusion of the number of stockholders and that of the stockholdings. Specifically, the number of small holders (such as those with less than 100 shares each) may constitute a large majority of the owners of record, but their combined holdings may represent only a small minority of the total outstanding shares. Complete statistics covering this aspect of corporate ownership are lacking, but a check of specific companies would undoubtedly confirm the observation. For example, we may

[5] *Share Ownership in America: 1959* (New York, N.Y.: New York Stock Exchange).

note the condition as it relates to the General Motors Corporation. As of December 31, 1949, stockholders each owning 50 shares or less represented 78 per cent of the 434,075 total shareholders, and the remaining 22 per cent accounted for a large majority of the 44,104,340 shares then outstanding.

Evaluation of such statistics as the foregoing is, of course, subject to various elements of influence. Thus, the increasing popularity of common stocks during recent years has undoubtedly added to the volume of small holdings. Also stock splits, for mathematical reasons alone, serve to decrease the percentage bracket of small holders of stock of the companies involved. For example, if the holders of 100 shares or less represented 80 per cent of all shareholders as of a given date, a stock split of 2 for 1 would inevitably remove all previous holders of 51 to 100 shares from this category. In the case of the General Motors Corporation, we do not have the facts to report the immediate results of the stock split of 2 for 1 as of October 2, 1950; however, as of August 8, 1955, we do know that those holding 50 shares or less decreased to 60 per cent of the total shareholders.[6] The stock of this corporation was further split 3 for 1 in September, 1955, which would naturally cause an even more precipitate drop in the small-holder group—measured in terms of the number of shares.

The pattern of relationship between the *number* of shareholders and the *amount* of shareholdings is by nature likely to be of the inverse type. As further confirmation of the point, we may note the findings of a comprehensive earlier study made by the Temporary National Economic Committee. An analysis of 1,572 corporations with a total of 11,432,992 shareholdings showed that 9,884,962 (or 86.5 per cent of the total) were holdings of 100 shares or less. The large number of small holdings did not represent a large portion of the total shares, however, because the 86.5 per cent of total holdings represented only 16.5 per cent of the total shares outstanding and 20.5 per cent of the total value of the shares as of December 31, 1937.[7]

INFLUENCE OF STOCK PRICE AND CORPORATE SIZE

There is rather common belief that small investors are likely to show preference for low-priced stocks; however, analysis of shareholdings does not afford any substantiating evidence of this view. For example, the American Telephone and Telegraph Company is well known for its large number of small shareholdings, and its stock has sold at a comparatively high price over an extended period of time. A comprehensive analysis of 1,710 listed corporations made in the late thirties also gave similar results.

---

[6] Based on correspondence with General Motors Corporation.

[7] Temporary National Economic Committee, *Survey of Shareholdings in 1,710 Corporations with Securities Listed on a National Securities Exchange* (Monograph No. 30 [Washington, D.C.: U.S. Government Printing Office, 1941]), Table 2, p. 65.

The proportion of closely held stocks which sold for less than $10 per share was nearly twice that of widely held stocks. Stocks selling for $10 to $30 per share made up 20 per cent of the shareholdings in the closely held group and 31 per cent of the widely held stocks. Among the closely held issues, 5 per cent were selling for $60 or more per share, whereas 12 per cent of the widely held issues were in that price class.[8] The reasons for this distribution are not entirely clear. It may be due to the tendency of public interest to center in the leading corporations with national reputations. Such corporations issue stocks in the higher-price brackets. Again, the wider following and more active trading may influence the price.

TABLE 24

SIZE OF SHAREHOLDINGS CLASSIFIED BY SIZE OF CORPORATION, 1937–39*

Assets (Millions of Dollars)	Number of Shareholdings	Percentage of Holdings—100 Shares or Less	Percentage of Holdings—over 100 Shares
Under 1	138,127	63.5	36.5
1 and under 5	655,460	77.9	22.1
5 and under 10	602,117	84.0	16.0
10 and under 20	659,247	84.0	16.0
20 and under 50	1,274,810	86.4	13.6
50 and under 100	1,036,280	87.5	12.5
100 and under 200	1,444,113	87.1	12.9
200 and under 500	1,651,332	87.4	12.6
500 and over	3,971,506	88.6	11.4
Total	11,432,992	86.5	13.5

* Temporary National Economic Committee, *Survey of Shareholdings in 1,710 Corporations with Securities Listed on a National Securities Exchange* (Monograph No. 30 [Washington, D.C.: U.S. Government Printing Office, 1941]), Table 2, p. 65.

With respect to the relationship between corporate size and shareholdings, there is some indication that small shareholdings may occupy a less prominent niche in corporations of $5,000,000 and less. The pattern of holdings may be seen in Table 24, which reports the holdings by sizes of corporations as indicated.

STABILITY OF SMALL HOLDINGS

Of import to financial policy, also, is the relative stability of small holdings. Do they constitute a form of flighty capital? Are they easily dislodged by adverse trends in stock prices? Once again it is difficult to obtain comprehensive or long-term statistics, but it may be of interest to observe some of the changes that occurred during the severe market crash of 1929 and the further response during the early part of 1930.

[8] Temporary National Economic Committee, *op. cit.*, p. 41.

Table 25 shows the number of stockholders reported for the indicated companies at the end of the third and fourth quarters of 1929. The movement of common stock prices during 1929 and 1930 was unusually wide. The high for the Dow-Jones industrial average was reached on September 3, 1929, at 381.17. Following the crash in October, it fell to 198.69 on November 13. The average then moved upward to 294.07 on April 17, 1930, following which it moved to a low for that year of 157.21 on December 16. (The record low for the Dow-Jones average was 41.22, reached on September 7, 1932.)

Since the initial break in the stock market occurred on October 24, 1929, it might have been expected that by the end of December many small stockholders would have sold their holdings to larger, better-financed investment interests. Extensive liquidation did take place on an unprecedented scale; but it must be remembered that, for every sale,

TABLE 25

NUMBER OF STOCKHOLDERS REPORTED BY SELECTED CORPORATIONS, THIRD AND FOURTH QUARTERS, 1929*

Company	Third Quarter	Fourth Quarter
American Tobacco Co.	23,067	22,557
Associated Gas and Electric Co.†	104,080	190,139
Baltimore and Ohio Railroad	31,823	34,783
General Foods Corp.	21,810	24,208
Montgomery Ward & Co.	20,941	44,989
New York Central Railroad	51,835	50,711
Public Service Corp. of New Jersey	20,059	22,441

* Direct correspondence with corporations.
† June 20 and December 31 statements.

there must be a purchase. As may be seen in Table 25, the number of stockholders increased in all except two companies, which had minor declines. In part, this stability in ownership may be the result of transfers of stock held temporarily in "street names" to the real owners; but, in addition, it is likely that many were tempted to buy new or additional holdings, thinking that the sharp break created an opportunity to invest at favorable prices. Undoubtedly, few people realized that the stock market break was the opening wedge for the greatest depression in the history of American business. Again, the commitments may have reflected the persistence of the belief that the course for American business must ever be upward and onward. While the companies shown in Table 25 constitute only a small percentage of the total, their diversified ownership makes them an excellent index of public reaction.

The behavior of small investors during the severe crisis indicates further the potentialities of this group as a source of capital. Admittedly, there may be a fairly high rate of turnover of ownership; but, in the aggregate, small investors provide a diversified and steady supply of funds.

Additional evidence is found in the continued increase in the number of stockholders in the early part of 1930. Table 26 gives the number of stockholders at the close of 1929 compared with the number for 1930 at the close of the first quarter, the close of the first half, or early in October, on whichever date it was possible to obtain the data.

The increases in the number of shareholders during the thirties are so surprising as to suggest some questioning of the results. First, it is necessary to distinguish between the total holders of record and the actual number of stockholders. They would be identical in the case of a single company; but, because of multiple ownership, holders of record would obviously exceed the number of separate stockholders in a group of com-

TABLE 26

NUMBER OF STOCKHOLDERS OF SELECTED CORPORATIONS, AT CLOSE OF 1929 AND EARLY 1930*

Company	Number of Stockholders	
	Close of 1929	Early 1930
American Telephone and Telegraph Co.	469,801	525,000
General Electric Co.	49,882	73,320
General Foods Corp.	24,208	27,060
Montgomery Ward & Co.	44,989	54,206
National Biscuit Co.	14,629	16,770
National Dairy Products Co., Inc.	28,652	33,189
North American Co.	36,025	39,069
Pacific Gas and Electric Co.	24,015	26,039
Sears, Roebuck & Co.	18,222	25,244
United States Steel Corp.	117,956	129,626

* Direct correspondence with corporations.

panies. Or, to state the condition conversely, a single individual or institution may own stock in more than one corporation. In an analysis of 1,710 corporations as of the year 1937, one study has shown an estimate of 5,000,000 different stockholders as representing 14,000,000 "record shareholdings."[9]

Second, changes in the number of shareholders may be more apparent than real, i.e., technical instead of genuine. Thus, during the period preceding 1929, there was considerable trading on the margin, where the securities were retained by the brokerage house under what is known as a "street name." As a result, many different investors or speculators may have the real title to the stock; but the corporation records will show only the name of the brokerage house or some other nominee. Naturally, if the investors actually take over the stock, there is no basic change in the ownership, since only a technical transition in title is effected. However, it is not believed that there was sufficient volume of this type to have had any material effect upon the results over such a long period of time.

[9] Temporary National Economic Committee, *op. cit.*, p. 6.

SIGNIFICANCE OF SMALL SHAREHOLDINGS TO FINANCIAL POLICY

Fortunately the stock-market debacle of 1929 and the ensuing early thirties has not since been repeated. Of course there have been adjustments of lesser magnitude, and these undoubtedly test the nature or character of stock ownership. Based upon the performances recited above and upon reactions to market setbacks since the thirties, there is reason to believe that large holders of stock—the so-called "smart money"—may liquidate their holdings on a strictly opportunistic basis and that they are absorbed by the public at large. This means that business risks are being assumed by the average citizen, who is generally less able to bear the risks attendant upon business activity, or who, at least, usually lacks the reserves to bear the risks that have been typical of business in the past. In response to this manifestation of faith on the part of the general public, management must more than ever adopt the public-service point of view as well as provide complete accounting for the capital entrusted to its administration. To a great extent, governmental policies in recent years have been directed to these ends; but, at the same time, many additional burdens are imposed upon private management. In many ways, the enlarged scope of governmental functions, with their resulting tax burden, makes the problems of management more numerous and complex than ever before. In spite of this, the duty of management is clear.

THE NEED FOR REPORTING

As the number of stockholders increases, the public obtains a constantly greater interest in the welfare of corporate activities. This creates a moral obligation on the part of the corporation to keep its stockholders and the public at large informed of its current operations and developments. Awareness of this need for adequate reporting is increasing and is given broad and realistic expression in the following statement made by the Chairman of the Finance Committee of the United States Steel Corporation:

> In my thesis, therefore, the annual report is not merely a legal requirement in which the stockholders, the employees and the public are furnished with a tabulation of bare figures which satisfy the legalities but which give little hint as to what the figures mean or how they are arrived at. We ought to know by this time that secrecy in business may be ignorance in business and is only a way of inviting others to do the explaining for us. It is our own fault that we spend as much time trying to catch up with and explain misstatements about ourselves which could never have been made had we clearly stated the facts in the first place. *I regard the social obligation fully to report as infinitely higher than the legal obligation.* Perhaps it is not quite accurate to use the word "obligation," for really the annual report is more an opportunity than an obligation. Even in the narrowest viewpoint, it is essential to continued progress that the public be given facts so that the workings of industry may be understood. Technically, it can be argued that an enterprise

need only report to its owners. But such argument, although technically correct, does not take into consideration public reaction.[10]

These views are representative of the attitude of many other corporations and augur well for the improvement of corporate public relations. In addition to the annual report, it is fairly common to make available to the stockholders and others one or more of the following:

1. Quarterly reports of earnings, as well as a letter from the president describing the status of operations, are issued by some corporations.
2. Special booklets and pamphlets are frequently distributed.
3. Information about the products of the company is frequently sent at the time of mailing dividend checks or by special forwarding.
4. Company magazines or house organs may be distributed to the stockholders as well as to other interested parties.

While it is true that the number of companies employing the foregoing tactics is entirely too few, still it is believed that a notable step has been made in the right direction. The practice of these policies indicates the existence of a sense of responsibility to the stockholders and reflects an underlying principle which is worthy of wholehearted support.

OWNERSHIP BY OFFICERS, DIRECTORS AND FINANCIAL AGENCIES

Stockholdings by corporation officers and directors usually represent a type of interest much different from that evidenced by the investment of the average person. The former are expected to have some stake in their company as evidence of their faith and belief, although this necessarily varies according to the size of the corporation. In small companies, it is not uncommon to find officers and directors holding a majority of the stock; in large organizations, this is not feasible because of the amount of the required investment. However, irrespective of the size of the enterprise, there is natural and inevitable concern about its control. For the large corporation, control usually is held by "inside management" which, in turn, is facilitated by the scattered nature of stock ownership and the accompanying use of proxies to give effect to the voting rights.

In the American Telephone and Telegraph Company, the combined shareholdings of all directors as of January 31, 1961, amounted to 8,078 shares, or only a fractional per cent of the 223,518,483 shares outstanding as of December 31, 1960.[11] The president and two executive vice-presidents, who are also members of the board, accounted for 3,078 shares. It is clear that with such minimum holdings of stock that reliance is placed upon the general facilities of control previously mentioned.

Table 27 shows the ten largest stockholders of the American Tele-

[10] Address of E. M. Voorhees before the Controllers' Institute of America, September 21, 1943, pp. 12–13, italics supplied.

[11] Letter of American Telephone and Telegraph Company to stockholders giving notice of the annual meeting, March 11, 1961, pp. 2–3, and Table 27.

phone and Telegraph Company as of December 31, 1960. The largest is a well-known brokerage firm; also, it is an example of holding stock in a "street name," i.e., for beneficial owners who may prefer to expedite more frequent trading in their security holdings. It is also likely that the other nine hold the stock for undisclosed real owners.

As noted earlier in this chapter, other financial agencies or media also account for sizable amounts of the shareholdings of corporations generally. Investment companies and trusts, while a relatively new development in this country, have experienced a rapid growth in the last decade or so; as a result, they may appear as important holders of stock. As the name suggests, investment organizations serve mainly to pool individual savings and then effect a diversification of investment. Pension funds operate in a

TABLE 27

TEN LARGEST STOCKHOLDERS OF THE AMERICAN TELEPHONE AND TELEGRAPH COMPANY—DECEMBER 31, 1960*

	No. of Shares
1. Merrill Lynch, Pierce, Fenner & Smith, Inc.	2,244,590
2. Atwell and Company	651,711
3. Sigler and Company	633,488
4. Gunther and Company	538,924
5. Societe de Banque Suisse	524,805
6. Egger and Company	465,786
7. Cudd and Company	407,686
8. King and Company	398,737
9. Credit Suisse	380,902
10. Pitt and Company	380,586
Total Shares Held by Ten Largest Holders	6,627,215
Total Shares Outstanding	223,518,483

* American Telephone and Telegraph Company, *Annual Report, 1960*, filed with Federal Communications Commission.

somewhat comparable manner even though their primary motivation differs markedly from the specialized investment institution. Further attention will be given to investment companies and pension funds in Chapter 17, but we may note at this point that such ownership may well play a distinct role in influencing control.

Not surprisingly, developments of the foregoing type have led to legislation designed to protect the public interest. Thus far, little has been done to regulate the investment activities of pension funds, but legislation regulating the operations of investment companies was enacted in 1940.[12] Also, the Securities Exchange Act (enacted in 1934) requires directors and officers to file with the Securities and Exchange Commission a report of their holdings of the stock of the companies they direct; in addition, purchases and sales of such stock must be reported monthly. While legislation of this general type may not wholly restrain the actions of insiders

[12] Investment Company Act of 1940.

and specialized holders of stock, it does serve to bring their activities into the open for public review.

CUSTOMER OWNERSHIP

The development of customer ownership is not equal in all fields, but it does offer special advantages to corporations when it may be utilized. For instance, many public-utility companies have promoted direct selling campaigns for the purpose of enlisting their customers as stockholders. Industrial concerns do not have either the incentive or the opportunity to pursue a similar policy because of the shifting character of their market; instead, they have reversed the process by inviting their stockholders to become customers.

Customer ownership gives rise to many questions of public policy, particularly as it relates to the public utilities. In many respects, the interests of customers and of stockholders are contradictory. The former naturally seek the lowest rate possible, whereas the latter would favor a rate that would produce the largest amount of profit. Reconciliation of their diverse interests may, therefore, remove a possible source of friction and opposition and thereby simplify the task of management. The resulting harmony must also contribute to the efficiency of operations.

Even more important in this day when public relations and policies are assuming greater importance, the alignment of customer and stockholder interests may prove to be of great value in creating good will. Various legislative measures are being enacted which seem to increase the conflict with private interests. It follows that sizable customer and public representation in the list of stockholders may be of profound influence and serve as a bulwark against encroachment by government. Undoubtedly, this concern for future position was one of the compelling reasons causing the public utilities to seek the support of their customers. Oppositely, the dangers of pressure or group interests were recognized by the government in the case of public-utility holding companies; and the house-to-house selling of securities by such companies was prohibited in Section 6 (*c*) (1) of the Public Utility Holding Company Act of 1935. Current statistics on customer ownership are lacking, but some idea of its extent may be obtained from the large number of stockholders of some of the leading public utilities listed in Tables 22 and 23 (pp. 255–56).

There are other advantages of customer ownership of a more immediate financial nature. This type of stockholder is apt to be a more permanent investor in the company irrespective of trends in security prices. As a consequence, customers may prove to be an excellent and reliable source of stable financing, as distinguished from the so-called "hot" money. Of less importance, customer stockholders constitute a means of expanding the company's sales of goods and services. Occasionally, a company selling consumer goods arranges for periodic sales of the product directly to

the stockholders of the company. An example of this is the policy of the National Dairy Products Company, Inc. in offering each Christmas to its stockholders the opportunity to purchase gift packages of products manufactured by one of the company's leading subsidiaries, the Kraft Cheese Company. Just how important this may be to the company's income is not known, but it is a clever advertising device and one that develops the personal interest of stockholders.

EMPLOYEE OWNERSHIP

In earlier years both labor leaders and financial interests were generally skeptical, to say the least, about the encouragement of employee ownership. Labor leaders were inclined to regard it as an attempt to check unionization and to retard the independent organization of labor. It was frequently regarded as a form of insidious paternalism. On the other hand, financial interests considered mainly the efficiency of employee ownership as a means of raising capital, and commonly considered it to be a costly method. Also, management was apt to be concerned about the resulting influence of labor upon general operating and financial policies.

While some of the foregoing thoughts may still linger in the background, the attitudes of both labor and management are now much broader and more positive. The latter group is keenly aware of the possible effects of union policies upon costs and net earnings; as a result, there is a feeling that labor should share some of the risks. And labor unions give evidence of increasing desire to obtain a stake in ownership as a means of supporting their position in seeking greater voice in the formulation of basic policies. The advancement of employee ownership is also encouraged by the generally prosperous economic conditions that have existed for a long period of time.

Whatever the causes of the transition of thought, the ownership of stock by employees by means of formal company plans is now the second most important means of stock acquisition. This may be seen in Table 28 which presents a summary picture of the various channels through which stock is first acquired. It will also be observed that the trend toward employee ownership is gaining momentum; as may be seen in Table 28, stock acquired under company plans became more prominent in the period 1956–59 than it was in the cumulative record.

To observe the more specific workings of employee-ownership plans, we may note the following two examples:

Dow Chemical Company. Since starting the employee-purchase plan of this company on October 25, 1948, eleven offerings of stock were made to employees to October 12, 1959. The number of shares made available for this purpose have ranged from 46,798 to 205,000. The last offering consisted of 120,000 shares at a price of $68.00 per share, at which time the stock had a market price of $90¾.

Westinghouse Electric Corporation. The plan for the purchase of stock by employees was inaugurated in 1950 by reserving 500,000 shares for this purpose. As of March 15, 1960, officers and employees had options to buy 1,011,827 shares of stock at prices ranging from $19.00 to $44.00 per share; at that time the stock was selling in the market at $49¼.

While stocks available to employees under company plans are naturally offered at a price below the market figure then prevailing, there is always the potential that the reverse relationship may develop in the future. Such a condition could easily lead to misunderstanding and dissatisfaction by

TABLE 28

MEANS OF FIRST ACQUISTION OF STOCK*

How First Acquired	Cumulative to Date		1956 to 1959 Per Cent of Total
	Number of Shareowners	Per Cent of Total	
Bought through broker	6,080,000	49.5	48.5
Through company worked for	2,592,000	21.1	27.2
Bought through bank	1,585,000	12.9	6.9
Through gift or inheritance	1,560,000	12.7	13.9
Other ways	381,000	3.1	1.5
Don't remember	86,000	0.7	2.0
Not classified	206,000	†	—
Total	12,490,000	100.0	100.0

* Source: Share Ownership in America: 1959 (New York, N.Y.: New York Stock Exchange), p. 24.
† Not included in percentage distribution.

the employees. In one early instance, employees of the Simmons Company had been offered stock at $101.50; but, shortly afterward, the stock broke in the market and was available at around $24.00 per share. To meet the situation, a group composed of the Simmons, Towne, and Vance families provided funds to cancel the subscriptions of the employees and to return the installments paid in, plus interest at 5 per cent.

RELATIONSHIP BETWEEN OWNERSHIP AND CONTROL

While the corporation has established itself as one of the most efficient means for raising capital, it has also been charged with all the evils of absentee ownership. Stockholders are inclined to take no active part in the management of the company and to remain entirely indifferent to the corporation's policies so long as they receive a reasonably satisfactory return. Even if there were a desire on the part of stockholders to take an active part in the corporation's administration, it would be physically impossible for a majority of them to attend a stockholders' meeting. Because of this, their right to vote must be delegated to specific parties.

The practice of designating others to exercise the stockholder's vote is

widely used and tends to concentrate the control of the corporation into the hands of a few. Concentration may result in bad consequences, but it is the only practical means of achieving an efficient administration of large-scale enterprises. The remedy for any evils which may exist does not appear to lie in the abolition of concentrated control but rather in correcting or preventing some of the present abuses. Sometimes, the control is concentrated in the hands of the minority through an active effort to attain a situation wherein a small group of insiders can wield virtually absolute control over the policies of the corporation. Although these individuals are usually stockholders, they do not as a general rule hold a majority of the stock. Instead, they obtain effective control through one or more of the following methods: (1) scattered ownership, (2) minority control, (3) special voting arrangements, (4) pyramiding of the corporate structure.

Scattered Ownership. It is obvious that the scattering of ownership facilitates the concentration of control into the hands of a few active individuals. Not only does the scattering make it difficult for the stockholders to attend stockholders' meetings, but in addition it discourages any organized action to remove the controlling management. It would be an extremely hard task to organize a sufficient number of the 1,754,200 stockholders of the American Telephone and Telegraph Company, each holding an average of 123 shares of stock (after 3 for 1 split in 1959), into a body with sufficient power and definiteness of purpose to wield much influence on the existing administration.

From the point of view of stability of financing, it should be recognized that wide distribution of stock is desirable. Widely held stock in small quantities results in greater stability of market action, which would not exist if the stock were held by a smaller number of individuals in larger blocks; and, from the corporation's point of view, a stable market action is of importance in obtaining further distribution of securities. Wide distribution of stock does add to the initial cost of flotation, but usually it is achieved indirectly by means of later purchase in the securities market.

The dispersion of ownership necessarily means that financial interest in the form of stock investment is not required to effectuate control. Instead, power of direction is achieved through technique or organization whereby the votes of stockholders are marshaled into the hands of a small group. Usually, this controlling element is the operating management, which automatically enjoys the right of self-perpetuation. Under the circumstances, there is a reversal of the normal, statutory flow of power so that the management directs and controls the stockholders instead of being selected by the stockholders with responsibility pointed to this end. Not only is this characteristic found in the operations of large stock companies; but it is equally a feature of large, mutual organizations, such as

the mutual savings banks and life insurance companies. Hence, there is need to keep in mind that the concentration of control is likely more a characteristic of the size and nature of operation than it is the result of form of legal organization.

Minority Control. On other occasions, the control center may be found in a minority financial interest instead of in the operating management. In this instance, the latter is usually subject to the wishes of the former; and the minority's investment serves as a sort of balance favoring the stockholders' interest as against management's. However, the pattern of organizing the control mechanism is essentially the same. This consists of a delegation of authority to a committee giving it the power to elect officers and to exercise the various powers of the shareholders at the annual meeting. Hence, those who name the members of this committee will automatically obtain control over the larger corporate body. The legal instrument which is used to create the power of attorney whereby a committee is authorized to act in behalf of the shareholders is a proxy.

The Proxy. Stockholders' meetings are required by law and can be held only if the stockholders are present or are properly represented. In the case of large corporations, particularly, it is neither feasible nor physically possible for the stockholders to attend in person in large numbers. However, the legal equivalent is effected by the use of the proxy, which is a formal document signed by the stockholder appointing certain individuals as his lawful attorneys to represent him at the meeting.[13] The following is a copy of the proxy used at the annual meeting in 1956 of the stockholders of The American Tobacco Company:[14]

PROXY The American Tobacco Company 56176

Important Notice—This proxy is forwarded by the Management, who request, if you will not be present at the meeting, that you fill out, sign, fold and return this proxy in the enclosed stamped addressed envelope.

( )
Name and Address of
Stockholder
( )

The undersigned hereby appoints **PAUL M. HAHN, JAMES R. COON AND RICHARD J. BOYLAN** proxies, with power of substitution, to vote at the Annual Meeting (including adjournments) of Stockholders of The American Tobacco Company, to be held April 4, 1956, for the election of directors, on Proposal A referred to below which is described in the Proxy Statement, and on any other business that may come before the meeting, with all powers the undersigned would possess if personally present.

---

[13] The term "proxy" is also used to mean the person or persons holding the authorization to represent and to vote the shares.

[14] For regulations covering the proxies, see pp. 271–72.

IF A CHOICE IS NOT SPECIFIED BELOW, THIS PROXY IS TO BE VOTED AGAINST PROPOSAL A.

Management recommends a vote AGAINST this Proposal.

( ) FOR
( ) AGAINST Proposal A

A majority (or, if only one, then that one) of the proxies or their substitutes acting at the meeting may exercise all powers hereby conferred.

Dated: ________________, 1956 ________________________(L.S.)
(Stockholder should sign here)

Company will fill in number of shares

______________ Shares Preferred
______________ Shares Common

When signing as attorney, executor, administrator, trustee or guardian, please give your full title as such.

Proposal A, to which reference is made in the above proxy, provides for an amendment to the by-laws to increase the number of directors from 19 to 20. The proposers of the resolution to bring this about point out that the existing board of directors is comprised of only employees of the American Tobacco Company, and contend that the public stockholders should be represented. The management responds that all of the stockholders of the company are public stockholders and that the record of the company shows no need for change. The proposal was defeated at the stockholders' meeting, more than 96 per cent of the vote being against its adoption (the same proposal lost by a similar vote at the 1955 meeting).

As a result of the difficulty of stockholders being present, plus the frequent lack of interest shown by them, the typical stockholders' meeting becomes largely a meeting of proxies. In recent years management has been giving more pronounced encouragement to attendance at the annual meetings, probably recognizing their value from a public relations point of view. Also, in various instances, minority interests have become militant in challenging the actions or record of those in power. However, it would be unusual for large corporations to have as many as one per cent of the stockholders present in person; and, under these circumstances, proxies may readily "become a device for continuing management in corporate office and for ratifying its policies."[15]

Since the stockholders are present largely in proxy form, great power is conferred upon those persons appointed to vote; and it is apparent that they may easily achieve their desired ends. However, on occasion, opposition develops; and there may be a mad scramble for proxies. The fight between John D. Rockefeller, Jr., and R. Stewart for the control of the

[15] See Andrew Downey Orrick, Commissioner, Securities and Exchange Commission, "Revised Proxy Rules of the SEC," *Commercial and Financial Chronicle*, Vol. 183, No. 5502 (January 26, 1956), p. 18.

Standard Oil Company of Indiana is a pertinent illustration.[16] Similarly, the defeat of the Childs brothers in the Childs Company not only affords an example of a scramble for proxies but also illustrates in a pronounced manner the entity of the corporation; even though the Childs interests were deposed from management, the name of the corporation remained unchanged for many years until early 1956 when it became the Hotel Corp. of America.

Proxy fights appear to increase in number in periods of prosperity, particularly if the subject companies fail to show satisfactory earnings. Other incentives of action by both inside and outside interests are: failure to pay dividends, disputed bonuses paid to officers, the desire to obtain minority representation, and the familiar clash of dominant or ambitious groups to win control. Of corporations whose stocks are listed on national security exchanges, it is reported that there were 19 contested elections in the fiscal year ended June 30, 1959.[17] Of these, 11 were contests for control, and management won in 8 instances; the opposition was successful in getting control of two companies, and the other case was settled by negotiation. Of the 8 contests which were concerned only with representation on the board of directors, management was victorious in 5, and nonmanagement representatives were elected in the other 3.

Although the "ins" usually hold the "trump cards" because of their control of company facilities, there are a number of cases in recent years in which the opposition has been successful in removing the old management. One of the most prominent examples occurred in 1954 when a group led by Robert R. Young succeeded in taking control of the New York Central Railroad away from the management group spearheaded by the president of the company, William White. The former obtained the backing of powerful friends who acquired, together with his own personal holdings, some 1,118,880 shares, or 17.4% of the total outstanding shares of the company; the management group had personal holdings of 106,000 shares, or 1.6% of the total. In the final tally of the results, the Young group received the vote of 3,407,512 shares, or 52.9% of the total outstanding shares; the White group received 2,340,237 votes, or 36.3% of the total shares; and 699,659 shares, or 10.8% of the total, were not voted.[18] An interesting sidelight is found in the large holdings of New York Cen-

[16] This was a fight between the operating management represented by Stewart and the minority financial interest of Rockefeller, in which the former was ousted. For further details, see A. A. Berle, Jr., and G. C. Means, *The Modern Corporation and Private Property* (New York: Macmillan Co., 1933), pp. 82–84. Also see Temporary National Economic Committee, *Bureaucracy and Trusteeship in Large Corporations* (Monograph No. 11 [Washington, D.C.: U.S. Government Printing Office, 1940]), p. 20, to the effect that the cost of obtaining proxies amounted to about $300,000.

[17] Securities and Exchange Commission, *Twenty-fifth Annual Report for the Fiscal Year Ended June 30, 1959*, p. 84.

[18] See Harold M. Newman, "Who's Going to be the Winner in a Proxy Fight?" *Investment Dealers' Digest*, October 3, 1955, p. 25.

tral stock in "street" names—some 40 per cent of the total shares, which voted approximately 2 for 1 in favor of the Young group.[19] It is estimated that about $500,000 was spent by the Young interests in waging the proxy campaign, and by the management group a slightly larger amount.[20]

Another case that was equally prominent in the public eye was the attempt in 1955 of Louis E. Wolfson to wrest control of Montgomery Ward & Co. from Sewell Avery, who had held the presidency of the company for the preceding 20 years. While the former failed to establish a majority position, he did succeed in obtaining 3 directorates as a result of the cumulative voting that was required in this instance. Shortly thereafter, Mr. Avery resigned and, in 1956, Mr. Wolfson resigned as a director, reporting that he was satisfied with the program of the new management. Generally, however, the cost of proxy fights serves to limit the chances of success by minority, or so-called "insurgent," groups, particularly in the case of large corporations.[21]

Recognizing the potential abuse of proxies, the Securities Exchange Act of 1934 declared it unlawful to solicit proxies by mail or other channels of interstate commerce "in respect of any security (other than an exempted security) registered on any national securities exchange in contravention of such rules and regulations as the Commission may prescribe. . . ." Applicable rules and regulations were first issued by the Securities and Exchange Commission in 1934. Among the more important provisions, as amended to 1960, are the following:

1. *Requirements as to the proxy.* A clear statement must be made as to who is soliciting the proxy; usually, this will be the existing management, and the names of the individuals must be indicated in "boldface type." Any other group desiring to solicit proxies must clear with the Securities and Exchange Commission before taking action. "Each matter or group of related matters intended to be acted upon" must be presented "clearly and impartially," and the form must provide "an opportunity to specify by ballot a choice between approval or disapproval" of the items to be voted upon.

2. *Material required to be filed.* "Three preliminary copies of the proxy statement and form of proxy" must be filed with the Commission ten days before the solicitation begins. Similarly, three preliminary copies of any "additional soliciting material" must be filed at least two days prior to its being sent to security holders. Four definitive copies of the foregoing must be filed or mailed to the Commission not later than the date the material is sent to the security holders. Also, soliciting material "in the form of speeches, press releases and radio or television scripts" must be sent not later than the date they are used.

3. *Proposals of security holders.* If any security holder indicates that he expects to raise certain matters of business at the meeting, "the management shall set forth the proposal in its proxy statement" and, "if the management

[19] See J. A. Livingston, "Is Central Proxy Vote an Augury for Avery?" *Washington Post and Times Herald*, April 20, 1955, p. 25.

[20] See *Fortune*, Vol. L, No. 2 (August, 1954), p. 87.

[21] See Lewis D. Gilbert, "The High Cost of Proxy Fights," *Investor*, October, 1950, pp. 29–31.

opposes the proposal," it must upon request state the name and address of the security holder and include his statement of "not more than 100 words in support of the proposal." There are qualifications that proposals must be proper and objective in nature; however, the Commission and the security holder must be notified of the intention to omit the material.

4. *Information required in proxy statement.* Some twenty-one items are set forth in the regulations that must be considered for inclusion in the statement accompanying the proxy. Illustrative of the features on which information must be given are: interest or connection of officers, directors and others in "matters to be acted upon"; bonus, profit-sharing plans, pension or retirement systems, and rights or options to purchase securities of the corporation; and "remuneration and other transactions with management and others."

The workings of these regulations is reflected in a summary way by the copy of the proxy of The American Tobacco Company previously shown. It is clear that management still retains a position of maximum influence; but stockholders are provided with a mechanism for playing a far greater part as an active policy-making force than was ever possible in the past. Still, some tantalizing questions will probably always remain. To what extent does management have a vested interest? How far should the government go in promoting the rights of minority stock interests?

Special Voting Arrangements. Outright provision for voting control may be attached as a special right of a particular class of stock, or it may be specifically effected by a voting trust. There is little need to discuss the former method because of earlier reference to this type of stock in Chapter 5. Similarly, special voting rights may be established in favor of preferred stock, to be exercised in the event of failure to meet the dividend requirements. However, large corporations seldom have need for such special stock because of the ease in effecting control by the minority methods described above.

Voting trusts represent still greater concentration of control, because final and absolute voting power is usually vested in a few individuals for a fixed period of time. Under this plan, stockholders deposit their stock with a depository in favor of the trustees and receive in return trust certificates. These may be bought and sold the same as any other stock certificates and are entitled to the dividends declared upon the deposited shares. The device is created under two sets of circumstances:

1. It is used as a means of providing centralized and positive control for a period following reorganization. This is illustrated by the 7 per cent cumulative prior preferred stock of the Virginia-Carolina Chemical Company, where a voting trust was ceated for a period of 5 years. Another instance is that of the Seaboard Air Line Railroad Company, where common stock was held in a trust pursuant to an agreement dated April 1, 1946. The trust had a life of 5 years; and at its expiration on March 31, 1951, the voting trust certificates were called for the purpose of exchange for the usual stock certificates.

2. Voting trusts may also be used by going concerns for the direct

purpose of expediting control. An example is the Brockway Glass Company, which renewed a previous voting trust in 1950 to run until 1960, unless terminated earlier by the trustees. Of the 65,219 shares then outstanding, it is reported that 51,651 were held by the trustees. In some companies where the law permits, cases are known in which virtually the same results are achieved by the use of perpetual proxies; such proxies are valid until revoked by the stockholders.

Brief reference may be made to the plan of cumulative voting which permits a form of concentration of voting so as to enable minority interests to gain representation. Under this method, each shareholder is entitled to a number of votes equal to the number of shares owned times the number of directors to be elected. This arrangement permits the stockholders to spread their votes or to concentrate them upon a single director or a limited number of directors. By mutual concentration, the minority element may usually be assured of representation on the board. Some states make cumulative voting compulsory—for example, Illinois, Michitan, and Pennsylvania.[22] In other states, such as Delaware, New York, New Jersey, and Maryland, it is permissive, thereby enabling corporations to use the plan by including it as one of the articles of incorporation or as one of the bylaws.

Pyramiding of the Corporate Structure. Another device which is employed to accomplish the concentration of control is the pyramiding of corporations on top of others in successive layers. By this means, the majority interest may be successively reduced in amount until it is readily financed by those seeking control. To illustrate, a corporation with capital stock of $100,000,000 would require one share more than $50,000,000 to assure positive control. If a second corporation were created with capital equal to this majority interest, it would then be possible to control the second corporation with one share more than $25,000,000. This process could conceivably be carried on ad infinitum until a relatively small amount would permit absolute control over a hierarchy of corporations. This method has been used extensively in the field of public utilities, as described in Chapter 29; but, since the thirties, its use has been restrained by specific legislation and by other public measures designed to restrain undue monopoly.

NEED FOR CONCENTRATION OF CONTROL

The various devices which are used to effectuate the concentration of control are often considered to be tactics of evil; and their very existence

[22] See Lewis D. Gilbert, "Cumulative Voting—Investor Protection," *Investor*, June, 1951, pp. 37–41, for statement that cumulative voting "is mandatory in 20 states and permissive in 13 more." Examples of corporations using the plan are Westinghouse Electric Corporation, Swift and Company, Caterpillar Tractor Corporation, and the Budd Company.

calls for condemnation. Actually, in any organization of large-scale operation, some form of orderly and centralizing procedure is essential to its proper functioning. Otherwise, disunity and various conflicts of interest would produce serious confusion and possible chaos. The primary test of its propriety, therefore, is whether or not it contributes to the best interests of the parties affected. If there is an unwarranted diversion of benefits from the many to the few insiders, then there is little justification for the concentration of control. On the other hand, if the delegation of authority by scattered owners of stock to a small group is exercised according to the real principles of true trusteeship, then both these owners and society at large may be the beneficiaries.

In the case of a small-scale enterprise, it is usually possible for the owner to exercise his authority directly. There need be little social concern for operations of this character because the responsibility is direct and absolute; in large-scale operation, it is the condition of absentee ownership which gives rise to many questions affecting the public interest. Society has long permitted great freedom in the exercise of rights that affect primarily the single individual; but when action by a single person affects the rights of others, then some form of government is necessary. This general principle is applicable, in a sense, to the operations of big business because its internal structure is largely the result of a delegation of power. This larger social attribute will be discussed at greater length in a following chapter after the nature of the management function has been described.

QUESTIONS AND PROBLEMS

1. Evaluate the public responsibilities of private corporations. Do you think they are best fulfilled by corporations living up to the full measure of their private responsibilities?
2. Would you favor different statutes to cover small and large corporations? Would such a plan differ materially from the present separate provision for public utilities, railroads, banks, etc.?
3. In your opinion, does the present widespread ownership of corporations by the public affect in any way the degree to which they should be regulated by public authority?
4. Evaluate the merits of installment buying of common stocks. Compare with the purchase of stocks on margin.
5. Discuss the meaning and implications of the term "constructive trust."
6. "Governmental regulation purports to aid the investor, but in the last analysis, the recognition of public responsibility by private management is the only sure way of safeguarding the interests of investors." Explain and comment.
7. "An illustration of the ruinous effect of governmental regulation on investor morale is found in the case of railroads. Stockholding lists are not expanding as rapidly as is true of public utility and industrial companies, which may suggest that when the government 'moves in,' the investor 'moves out.'" Comment.

8. How would attitudes of investment trusts as stockholders compare with those of individual stockholders? Compare as to alertness, continuity of ownership, and understanding of the problems.
9. "Customer ownership is simply a form of co-operative enterprise." Discuss.
10. "In the last analysis, there is little difference between a stock company which has only common stock outstanding and a mutual company." Discuss.
11. Evaluate the importance of ownership of stock by employees. Do you think that such ownership injects an element of democracy into capitalism that is essential to meet the demands of modern social movements?
12. "Nominees—mostly banks—hold stock in behalf of such types of investors as pension funds, personal trust funds and estates." (*The Exchange*, December, 1959, p. 15). Discuss the significance of such holdings to banks.
13. "Nonvoting stock and voting trusts are an honest way of centralizing control, whereas the intentional scattering of ownership and the use of proxies are subterfuges to accomplish the same end." Discuss.
14. The following votes on cumulative voting (see *Investor*, May, 1951, p. 39) were reported at annual stockholder meetings held in 1951:

American Tobacco Co.	Favor cumulative voting plan, 246,407; against, 5,218,201
Bethlehem Steel Corp.	Favor cumulative voting plan, 377,066; against, 7,069,092
National Biscuit Co.	Favor cumulative voting plan, 246,567; against, 5,580,442
Western Union Telegraph Co.	Favor cumulative voting plan, 177,067; against, 550,991

Comment on the results of these votes.

15. Discuss the ethics of proxy contests to oust management (*a*) by stockholders of long standing and (*b*) by new interests who acquire stock for this express purpose.
16. "One must respect the S.E.C.'s diligence about 'protecting the public.' It might be remembered, however, that soliciting votes is a free-wheeling American pastime." Discuss and indicate your views about the regulation of proxy contests.
17. Discuss the pros and cons of (*a*) cumulative voting and (*b*) of staggered terms of directors.

REFERENCES

Armstrong, J. Sinclair, Chairman, Securities and Exchange Commission. "The SEC and Proxy Contests," *Commercial and Financial Chronicle*, Vol. 182, No. 5460 (September 1, 1955), p. 7.

Crum, W. L. "Analysis of Stock Ownership," *Harvard Business Review*, Vol. XXXI, No. 3 (May–June, 1953), pp. 36–54.

Hunt, Pearson. "A Program for Stockholder Relations," *Harvard Business Review*, Vol. XXX, No. 5 (September–October, 1952), pp. 99–110.

Kimmel, Lewis H. *Share Ownership in the United States*. Washington, D.C.: The Brookings Institution (1952).

Livingston, J. A. *The American Stockholder*. Philadelphia, Pa.: J. P. Lippincott Co., 1958.

SANDERS, THOMAS H., COMPANY. *Annual Reports to Stockholders, Employees, and the Public*, pp. 66–72. Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1949.

STANLEY, W. F. "A Key to Good Stockholder Relations," *Harvard Business Review*, Vol. XXVIII, No. 4 (July, 1950).

TEMPORARY NATIONAL ECONOMIC COMMITTEE. *Bureaucracy and Trusteeship in Large Corporations*. Monograph No. 11. Washington, D.C.: U.S. Government Printing Office, 1940.

———. *The Distribution of Ownership in the 200 Largest Nonfinancial Corporations*. Monograph No. 29. Washington, D.C.: U.S. Government Printing Office, 1940.

———. *Survey of Shareholdings in 1,710 Corporations with Securities Listed on a National Securities Exchange*. Monograph No. 30. Washington, D.C.: U.S. Government Printing Office, 1941.

"Today's Management: Under New Ownership Tomorrow?" *Business Week*, June 18, 1955, pp. 140–47.

WHETTEN, L. C. *Recent Proxy Contests: A Study in Management-Stockholder Relations*. Atlanta, Georgia: Georgia State College of Business Administration, 1959.

WILLIAMS, CHARLES M. "Cumulative Voting," *Harvard Business Review*, Vol. XXXIII, No. 3 (May–June, 1955), pp. 108–14.

WILLIAMS, R. A. and ALLEN, SIDNEY P. "Is Cumulative Voting Sound?" *Investment Dealers' Digest*, sec. 1 (June 5, 1961), pp. 26–27.

Chapter 15 ►

MANAGEMENT AND POLICY FORMATION AT THE TOP

THE STRUCTURAL composition of the corporation consists of a financial framework superimposed upon a foundation of legal organization. But to understand the driving force of corporate activity, it is necessary to look behind this outer shell and to observe its internal functioning and motivation. Just as a house is converted into a home by the process of living, so the corporation is transformed from an inanimate, technical machine into an animate, living force by its day-to-day operation. In a way similar to that of human beings, corporations develop personalities—strong or weak, attractive or repulsive, kind or cruel; all these features are molded into a single entity. The corporate life which is thereby generated reflects the expression of its inner force—management at the top.

By "management at the top" reference is made to the directorate, and particularly the small inner group, which shapes the directional pattern of a corporation. In addition, it is a force of co-ordination which gives a sense of oneness to the diverse operating divisions. Consistent with the theme mentioned in the introductory chapter, it should be emphasized that finance provides the criteria for evaluation of both performance and future prospect.

Methods of production, processes of selling, and various forms of administrative technique are usually adopted in the light of financial effect. Not only does the latter include the relationship between sources of funds and these branches of business operation; it also embraces the ultimate objectives of earnings results and of sound and successful operation. In this larger sense, finance serves as a yardstick by which management makes decisions and determines underlying policies of operation.

WHO CONSTITUTES MANAGEMENT?

The lack of preciseness and standardization of business and economic terminology makes it desirable to state who constitutes management. Commonly, management is interpreted to mean those in charge of the

area of production, particularly the heads of operating departments, and often excludes those engaged in selling and administration.[1] Actually, these individuals are only the agents of management and should be distinguished from the smaller central group which determines the policies to be put into effect. Various supervisory heads may assume great dignity and create an imposing front by the exercise of authority, but they are still subordinate in their capacity. As in the army, numerous lieutenants, captains, and other officers are necessary to put the orders of headquarters into effect. But to understand the fundamental tactics employed in troop movements and the planning of major campaigns, one must look to the small general staff at the top. Equally so in business enterprise, the formulation and direction of basic policy are highly centralized.

The management functions of the corporation are directed by a small group of executive officers and the board of directors. Incorporating statutes prescribe that every corporation shall have a board of directors and usually, but not always, stipulate that the corporation shall have a president and a secretary.[2] The actions of the executive group are directed normally by the president, although many exceptions are found in practice.[3] In the performance of his office, the chief executive officer works through operating departmental heads and various staff officers who act in an advisory capacity. Irrespective of the terminology used to designate the executive head, his chief function is the direction of operations.

The duty of the board of directors is, on the other hand, the determination of basic policies. The operating head will necessarily make many recommendations involving questions of policy, but final decision is supposed to be the product of group thinking and deliberative meetings by the board. The law has recognized the importance of group thinking by the board of directors in the development of the legal rule that a decision of the individual directors—even a unanimous decision—is ordinarily not valid as action of the board or binding on the corporation if the decision of each director was given separately and without a meeting of the board.

The general rule of law covering group action is stated in Fletcher, *Cyclopedia of the Law of Private Corporations*, as follows:

> By the overwhelming weight of authority, when the power to do particular acts, or general authority to manage the affairs of the corporation, is vested in the directors or trustees, it is vested in them, not individually, but as a board, and, as a general rule, they can act so as to bind the corporation only when they act as a board and at a legal meeting, unless the corporation has estopped itself, or has ratified the acts of the individual directors by receiving and accepting the

---

[1] There is also another possible definition of management as a process or force that merges the various seemingly independent units into a common whole.

[2] *Stevens on Corporations* (St. Paul: West Publishing Co., 1936), p. 640.

[3] For example, the chairman of the board of directors may hold the dominant position; also, someone junior in titular rank may be named, such as an "executive vice-president."

benefits of their acts adopted in such manner, and this rule applies to the meetings of the board of directors of banking corporations.[4]

The reasoning that underlies the rule is well stated by the court in the case of *Ames* v. *Goldfield Merger Mines Company*, as follows:

> The stockholders of a corporation have a right to expect from their directors a conscientious consideration of every proposition which is presented which involves any interest of the company, in conformity to the oath to which they have subscribed. They have a right to have the individual viewpoint of the several directors expressed at a conference, for the purpose of obtaining the exchange of view of the several persons in arriving at conclusions after deliberate consideration of any issue. It is fundamental that officers of boards can only act as such constituted boards when assembled as such, and by deliberate and concerted action dispose of the issue under consideration, and that they cannot act in an individual capacity outside of a formal meeting, and a majority of the individual expressions be the action of the board. The law believes that the greatest wisdom results from conference and exchange of individual views, and it is for that reason that the law requires the united wisdom of a majority of the several members of the board in determining the business of a corporation. . .[5]

COMPOSITION OF THE BOARD OF DIRECTORS

Because of the tendency to think in terms of a model or an ideal, it may be stressed that there is little uniformity of thought about the composition of a board of directors. The concepts of the "best" board or of the qualifications of individual directors are as varied as is personal opinion—even when it is the expression of informed or experienced judgment. Criticisms of directors are both colorful and thought-provoking, as may be seen in the following quoted observations:[6]

> Directors are complacent and not deeply concerned over their responsibilities; they lack a profound interest in corporate welfare. "Stuffed shirts."
>
> Directors, irrespective of whether they are executives or nonexecutives, are not independent; they often fail to have the stockholders' point of view. "Rubber stamps."
>
> Directors do not know what their duties are. They are mainly "façade or window dressing."
>
> Directors act on problems about which they have too little knowledge.

Aside from these opinions, which are mainly expressive of qualitative characteristics, it may be said that the cleavage of opinion develops usually from a difference in thinking about the desirability of the representa-

[4] William Meade Fletcher, *Cyclopedia of the Law of Private Corporations* (rev. and permanent ed.; Chicago: Callaghan & Co., 1931), Vol. 2, sec. 392. Application of the rule is illustrated by the case of *Baldwin et al.* v. *Canfield,* 26 Minn. 43 (1897), in which a conveyance of land belonging to a corporation was held ineffectual because it was executed in the name of the corporation by all directors acting separately and not as a board, and without previous authorization by the board.

[5] 227 Fed. 292, 301 (1915).

[6] Selected from various comments such as that by J. C. Baker, "The Board of Directors—Duties and Responsibilities," *Dun's Review,* February, 1946, p. 13.

tion of outside and various special interests. Other issues are the size of the board, the age of its members, the requirement of stock ownership for membership, and numerous minor features which do not lend themselves to convenient classification. Each of the more important items may be treated in its individual setting.

The Case for "Outside" Representation. Although directors are the elected representatives of the stockholders, their duties as a board are broad and comprehensive. Granted that the board has the primary responsibility of serving the best interests of the shareholders, it does not follow that this objective is attained by the pursuit of narrow, corporate introspection. On the contrary, there is increasing need for awareness of general social and economic trends and for the development and maintenance of proper relations with labor and the public. "It is becoming clear that in our modern society top management has the opportunity—in fact I should say the duty—to act as a balance wheel in relation to three groups of interests—the interests of owners, of employees and the public, all of whom have a stake in the output of industry. Management can best represent the interests of ownership by acting fairly and wisely with respect to the claims of employees and public as well."[7] Such is the line of reasoning which is often employed to support the case for outside representation on the board of directors.

A more realistic argument for the election of so-called "outside" directors is the gain that may be derived from their personal influence. Corporations may look to their board members for a variety of practical, business reasons. Specialized corporations in the more recent fields of electronics, missiles, etc., may try to obtain former military personnel, both because of their knowledge and contacts. Again, the banker may be chosen because of his financial connections; the director of some other company may be favored to get an inside track to supply sources; and, today, the labor leader may be sought to improve the liaison with employees. Diplomacy forbids giving exact expression to the motive, and there is seldom an unethical purpose in mind, but the objective is clear. Moreover, there is much to be said in favor of balancing a board in this manner, assuming, of course, that the individuals have the other requisite qualifications of directors.

Another form of outside representation is found in noted personalities whose names are believed to give prestige to the corporation. College officials and professors, authors, and miscellaneous prominent citizens provide a roster for the search for such talent. No generalization may be made as to the effectiveness of such directors, but often they may add a degree of independence which is all too frequently lacking in the consideration of policies and operations.

---

[7] "Developing Tomorrow's Business Leaders," *The Lamp* (official organ of the Standard Oil Company of New Jersey), February, 1946, p. 3. However, see p. 281 for the means by which this company obtains outside opinion.

Trying to summarize the case for a board made up mostly of outsiders, it may be observed that much may depend upon the size and the character of the operations of the corporation. Small companies may have greater need for outside influence and prestige than large institutions. Also, their operating problems are usually less complex; and they are likely to have more community spirit. Corporations of a distinctly public-service character, such as railroads, public utilities, banks, etc., may be expected to look for diversified public representation because of the nature of their business as well as for political reasons. Many of these same arguments may be applied to the large industrial corporations; but the issue is more sharply drawn, as we shall see in the following discussion.

The Case for the "Inside" Board. All boards usually have some representation by the corporate officers; the president is invariably a member, and it is fairly common to have the legal counsel serve. However, some corporations have boards that are composed exclusively of the executive operating personnel. This condition takes on more prominence in the large corporation; but it is not unknown in smaller companies, even when they are not family affairs. Again, there is a sharp difference of opinion; and the breach between the proponents and opponents is wider. For example, one observer has said: "I believe that the principle of having most of the Board of Directors come from the officers of the corporation, such as it is in the case of General Motors, is basically wrong." But another authority stated: "Hence General Motors' decision not to clutter up the Board of Directors with outside members but to restrict it by and large to top executives of the company, former top executives now retired, and top executives of the du Pont Company which owns a controlling interest in General Motors, is probably wise. But, of course, while this makes the Board of Directors usable as part of the executive organization, it does nothing to break the isolation of the executives."[8]

Probably the basic argument against outside representation on the board of a large corporation is that the directors would lack the knowledge and experience to make "know-how" decisions. To overcome the hazards of isolation of a self-contained board, the opinion of experts may be obtained on a conference or nonoperating basis. For example, the Standard Oil Company of New Jersey, which also has a board composed largely of directors with long experience in the business, states: "The Jersey board makes it a regular practice to invite to its meetings public leaders and experts in various fields to discuss current trends. The board is especially interested in views which may be different from its own. It seeks by such means to look at problems from all sides and to avoid the

[8] P. F. Drucker, *Big Business* (London: William Heinemann, Ltd., 1947), pp. 93–94. However, after a long dispute in the courts, the du Pont Company was ordered to dispose of its holdings of General Motors stock; currently, there is no interlocking between the two boards of directors. Also, as of the close of 1959, officers held only 7 of the 30 directorships.

danger of ingrowing thinking or an attitude of self-sufficiency. For the same reasons, outside experts are consulted from time to time on questions of major significance."[9]

It is clear from this brief review of the question that the strength of the "inside" board is to be found in its expert knowledge of operations and in the facility of executive direction; its weakness comes mainly from its self-contained character. Conferences with experts may be used to offset this basic shortcoming, but they can never supply the independence and objectivity that may prove vital over a long period of time. Few vice-presidents can meet on a level with the presidents, even though they may be members of the board. Granted, too, that outside directors may lack technical qualifications; they may, if properly selected, make a contribution that is particularly essential for large corporations.[10] More than ever, they must respond to the external social and economic problems; and there is always the hazard of being branded as a monopoly. Size invites the public eye, and public representation on the inside may soften the glassy stare.

Size of Board and Age of Members. Not too surprisingly, the size of a board of directors has no clear-cut pattern, irrespective of the size of the corporation. The small company with assets of no more than $500,000 may have 25 members on its board, and the condition is likely to be only a matter of "happenstance"; another may have only 5 members. Large corporations present a similar picture, and the proportion of inside and outside representation seems to be a conditioning factor of only minor influence.

For the sake of example, we may note that Texas Instruments, Inc., a speculative favorite in recent years, has a board of directors of 9 members, of which 6 are officers; in the case of Litton Industries, Inc., previously discussed in Chapter 11, there are also 9 directors of which 4 are officers. However, the General Electric Company has a board membership of 18 with only 2 officers represented. Probably there is some tendency to have smaller boards of directors because of the unwieldy nature of a large group; more specifically, there seems to be growing reluctance to increase the board beyond 9 or 10 members.

With all due respect to the many capable older citizens, it may be observed that possibly there are too many of them on boards of directors. Their experience and knowledge are often invaluable; but there are many cases, too, where they serve only for honorary reasons, and they are often inactive. It is likely that more personal sentiment is found in arranging for directors than in any other phase of corporation activity. However, from a strictly business point of view, the proper balancing of a

[9] *The Lamp, op. cit.*, p. 2.

[10] The American Telephone and Telegraph Company is an example of a large company with minimum inside representation—only three executives being on the board.

board requires a reasonable distribution as to age as well as to other qualifications.

Requiring Directors to Be Substantial Holders of Stock. Another proposal which is advanced to secure more effective administration of corporate affairs is that directors be required to own stock of the corporation. Before discussing the merits of a requirement that directors be shareholders, as well as the amount of stock which they may be compelled to hold, it will be helpful to examine briefly the legal status. The common-law rule is that, unless required by statute, the articles of incorporation, or the bylaws of the corporation, a director of a private corporation need not be a shareholder.[11] It has been customary in the past for general incorporation statutes to stipulate that directors must be holders of stock;[12] but revision of these statutes in recent years has often eliminated shareholding as a prerequisite to election to the board, except where the shareholders themselves impose such a requirement in their articles or bylaws.[13]

Furthermore, where a requirement that directors must be shareholders does exist, its practical effectiveness has been weakened by the rule, followed by the overwhelming majority of the courts, that a person who holds the naked legal title to stock on the books of the corporation is qualified to act as a director, even though the beneficial ownership of the stock may actually be in another person.[14]

Provisions specifying the amount of stock which must be held to qualify as a director are much less common, although such provisions do exist in the corporation statutes of some states. For example, in Kentucky, earlier statutes stipulated that a director had to own in his own right at least three shares of capital stock.[15] In Montana and South Dakota, directors are required to hold shares in an amount fixed in the bylaws.[16]

A financial stake in a business would obviously create a keener and

---

[11] Fletcher, *op. cit.*, sec. 299.

[12] *Stevens on Corporations*, p. 611.

[13] *Ibid.*, p. 612. See, e.g., California Corporations Code, sec. 804; Idaho Code, sec. 30–139; Louisiana Revised Statutes, sec. 12:34; Massachusetts General Laws, chap. 156, sec. 22; Michigan Statutes Annotated, sec. 21.13; New York Stock Corporation Law, sec. 55; Ohio Revised Code Annotated, sec. 1701–56. In some of these statutes—Massachusetts and New York, for example—directors must be shareholders unless the articles otherwise provide; whereas in others—California and Michigan, for example—they need not be shareholders unless the articles or bylaws so provide. The Ohio provision states: "The directors shall have such qualifications, if any, as are stated in the articles or regulations."

[14] Fletcher, *op. cit.*, sec. 300.

[15] Kentucky Revised Statutes, sec. 271.345, now require that there must be a board of at least three directors, who need not be shareholders unless the articles of incorporation so require.

[16] Revised Codes of Montana Anno. (1947), sec. 15–401; South Dakota Code (1939), sec. 11.0705.

deeper interest than would otherwise be true. There are many instances where individuals have served capably and conscientiously without having personal investment in an enterprise, but this does not warrant the broad conclusion that the system is universally good. Usually, these individuals have been motivated by a fine sense of public service which ought to be cultivated and encouraged. If applied with moderation, the requirement of an investment to qualify as a director need not destroy the larger, moral values of altruistic endeavor.

The amount of investment which may be required for qualification would be a matter of personal opinion. However, it would seem that a nominal amount would best serve the purpose, particularly if outside interests are to be attracted. Indeed, there may be weaknesses in requiring a large personal investment. Such directors may be overly conservative and lack the daring and initiative to meet competition. Desirable ventures into new lines or markets may be discouraged because of the fear of personal loss. Often, there are conflicts between the chief executive and the board of directors on whether to "stay put" or to operate vigorously. Under full competition, there is little need to attach much significance to these personal pressures; but where control of market or other forms of monopolistic practice are present, they may become a matter of concern.

COMPENSATION FOR DIRECTORS

It is fundamental in our law that directors are not entitled to compensation for services rendered within the scope of their duties as directors.[17] Compensation may be authorized by the charter, by the bylaws, by a vote of the shareholders, or by the directors acting under authority conferred upon them; but without some such special provision, remuneration for services as a director is not made. The rule is founded on the presumption that each director will have a stock interest sufficiently large to justify his devotion to the corporation without other reward.[18]

In practice, directors are usually paid a nominal amount for their services on an expense account or per diem basis. This fee is provided for in the bylaws and is payable for each meeting or each day the board is in session. There is little standardization in the rates paid to directors because of variation in the size of corporations and the amount of time required, but an annual return of from $1,000 to $2,000 may be common. In a study of 333 companies made a few years ago by the National Industrial Conference Board, it was found that a fee of $100 per meeting was most representative. At such compensation, it is apparent that the acceptance of directorships must be for reasons other than direct financial return. As already stated, these reasons consist of opportunities gained by inside con-

[17] *Stevens on Corporations*, sec. 157.

[18] *Navco Hardwood Co.* v. *Bass*, 214 Ala. 553 (1925); *Fox* v. *Arctic Placer Min. & Mill. Co.*, 229 N.Y. 124 (1920).

nections, favors or accommodations for influential friends, and undoubtedly, often the desire to render a public service.

To give more substance to directorships, there is considerable merit in placing the directors on a fixed salary and possibly having them function full time. There is precedent for this form of organization, and experience to date has been largely favorable. Thus, the use of full-time city councilmen under the city-manager system has demonstrated many benefits. In England, professional directors, who may serve many corporations, are properly compensated; and their relationship is on a strictly *quid pro quo* basis. There has been some recognition of the need for more active participation by directors in the functioning of private corporate affairs as well as the desirability of more adequate remuneration.[19] Commenting on these features, a former member of the Securities and Exchange Commission said:

> Many of the deficiencies of our modern directorates result from the presence of so many inactive directors on so many of our larger boards. In many of our directorates there are business colonels of the honorary type—honorary colonels who are ornamental in parade but fairly useless in battle; men whose fathers and uncles perhaps were generals but who themselves are qualified to command only by the virtue of the uniform they wear. . . . The term "paid director" may come as a novelty, but there is really nothing startling about the idea. Perhaps we might put it better by saying that we need more efficient directors and we can get them only by putting the position on a salaried basis.[20]

In appraising the activities of directors in corporate management, it should be noted that most boards appoint a number of committees to give special attention to specific areas. Probably the most common and important of these committees is the "executive committee" which, as the title indicates, is charged with the responsibility of working with the full-time management in the carrying out of board policies. Additional fees or compensation is paid to members of the executive committee, and the result is to approach in some ways a "job" status as distinguished from the more familiar "honorary" nature of the office.

THE ENLARGING ROLE OF THE BOARD OF DIRECTORS

There is considerable awareness today of the part which management plays in the operation of business enterprise. Not only is it regarded as a key factor in the success of a specific company but, also, its aggregate influence is recognized as being of vital importance in the march of our

---

[19] See *Business Week*, September 13, 1947, pp. 90–93, reporting that the National Industrial Conference Board of New York, in a study of 184 nonofficer directors of large corporations, found "more than half received $1,000 or more for their duties as directors. Almost one-third were paid regular salaries of $5,000 or more."

[20] Address of William O. Douglas, Chairman, Securities and Exchange Commission, at a luncheon of the Fort Worth Clearing House Association, Fort Worth, Texas, January 9, 1939, pp. 1–6.

economy. However, in thinking of management, there is likely a tendency to dramatize persons, or at least the executive direction of business activities. On the other hand, we may fail to appreciate the basic nature of the functions of the board of directors.

While it is true that leadership usually takes form by the actions of progressive and capable individuals there is, at the same time, pressing need for the balancing influence which may be exercised by a board of directors. Indeed, it is possible that the developments of recent times may be enlarging its role—particularly if we are to preserve the democratic features of capitalism. Undue dominance by a single individual may lead to a form of dictatorship—in business as in government.

Too often, operating officials are technicians who lack the perspective to appraise social and political movements which may exert great influence upon business trends. A board is usually less technical in character and reacts more readily to issues involving human relations. Moreover, its procedures, through discussion, lend themselves to the treatment of broad problems without precedent for solution. It is necessary only to think of the confusing and complex conditions of recent years to visualize the many enigmas confronting business management. Labor disputes on an unprecedented scale, money-market conditions which give evidence of numerous crosscurrents, spectacular and significant scientific and technological developments, irregular and uncertain commodity price movements—these and many other far-reaching issues force themselves on the agenda. It is expecting too much of a single individual to determine the course of action to take; much more logical is the determination of a policy through frank discussion around the board table.

Not surprisingly, in light of the previous comments, the public relations of modern business are rapidly assuming an importance that will affect materially the success or failure of any enterprise. It is now appreciated, as never before, that adverse public sentiment can do much to undermine the solvency of any enterprise, be it a public utility or so-called "private" business. On the positive side, there is increasing awareness that price, wage, dividend, and other policies must have general public approbation. To meet these new conditions, many corporations have created a specialized public relations staff to build proper public understanding; but to be successful, this department needs to work closely and to be in tune at all times with the board of directors.

Even in more functional terms, the composite thinking of a board should result in better judgment in various areas of activity. As in government, the conduct of business involves actions that fit into the three familiar categories of executive, legislative, and judicial. While the responsive measures of action may not be segregated as distinctly by industry as by government, the recognition of their nature should promote more efficient, long-term operation. The board of directors occupies a vantage

point favorable to the exercise of legislative and judicial duties, and the operating officials are better fitted to perform the executive functions. Included in the legislative group of activities would be found the various acts of policy formation; actions of a judicial nature would be required in settling interdepartmental disputes, disagreements between labor and operating management, etc.; finally, the executive functions would take form in the actual administration of operations.

EXECUTIVE DIRECTION AND POLICY

To complete the concept of management, brief reference should be made to executive direction and to corporate policy. The latter is not easily appreciated by casual observance, but it usually constitutes the difference between weak and strong operations. Only by having clear and well-defined policies can a corporation be given a sense of direction and an orderly plan for the pursuit of its business. It has been well said that "a policy is a management tool,"[21] yet there is a marked tendency to overlook its importance in corporate affairs. Also, it is probable that deficiencies of this type appear more frequently in small corporations than in larger organizations.

To formulate sound policies, there is need to bring planning and strategy into clear focus and to give them searching analysis and review. The agenda for the board of directors serve particularly to achieve this purpose and, in addition, help to tie executive direction into physical operations. Small businesses may readily fail to perceive the nature and importance of this feature because it is presumed that the owner is complete within himself.[22] However, some detachment is necessary for the evaluation of corporate policies; and it is achieved mainly by having a board of directors which is capable of sitting in the seat of judgment.

Probably the most vital quality in the operation of any company is the force of leadership; instead, the authority of mandate is all too frequently substituted. Almost always, leadership can be provided only by the chief executive, who is usually given the title of president. We need not analyze either his duties or those of various other officers because their activities are simply the means of carrying out policies. At the same time, there is need to stress that enduring policy can take form only by the development of proper liaison and understanding between operating officials and "top management." Individual presidents may frequently dominate and give leadership to the board of directors; but, in the long run, corpora-

[21] M. T. Copeland and A. R. Towl, *The Board of Directors and Business Management* (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1947).

[22] See booklet by Committee for Economic Development, *Meeting the Special Problems of Small Business* (New York, 1947), p. 23, for statement that "the number one problem of small business is management."

tions build for the future only by the formulation of policies that have momentum on their own account.

NEED FOR AUDITING CONTROLS

Although external auditing is not a part of the management process, some reference to its relationship should be made. The internal audit is an integral part of any complete accounting system; but more significant in many ways is the analysis made by the independent, outside auditing firm. Not only does such reporting have considerable value as a check upon the results of operation, but it is also a source of moral assurance to both the directors and stockholders—even though the auditors are by no means infallible. In some respects, the external audit is needed more in the case of the small firm than in large corporations. Internal checks and controls are apt to be less rigorous in the former because of the necessity of having a single person handle more than one function; in the large institutions, there is at least the double check of one person against another so that dishonest dealing remains concealed only by collusion.

In smaller companies, the sense of the independence of the corporate identity is also frequently lacking; and the president or some other key official may easily assume an authority that fails to respect the difference between corporate and personal affairs. For example, it is reported in a recent case that the chairman of the board, who is also the principal stockholder, of a relatively small company engaged in the following transactions:

1. Received a monthly rental of $3,100 from the company for a building for which he testified that he paid "either $100,000 or $150,000."
2. Borrowed "$150,000 from the firm's pension board at 2 per cent interest, later lending the firm $59,000 and $100,000 at 4 and 5 per cent interest, respectively." However, it was reported that neither the interest nor legal fees due him had been paid.
3. Charged personal living expenses to the company.
4. Received in 1946 a salary of $18,000 and bonuses amounting to $16,700.[23]

We leave the propriety of these transactions to the reader, but they clearly suggest some of the problems in failing to draw a sharp line between corporate management and personal activities. As stated on other occasions, it is likely that the corporation has too often become a form of personal convenience rather than of business facility.

Officials of large corporations may often spend freely from their expense accounts; and, indeed, they may be encouraged to do so in order to uphold the dignity of the corporate name. At the same time, the distinction between personal and corporate use is predetermined; and internal auditing controls are intended to bring the activities into the open. As a result, there is probably less intermingling of personal and corporate

[23] *Washington Post*, June 28, 1947, p. B-1.

funds than is true of small companies. But in either case, an annual, independent audit is highly desirable; and management responsibility is not fulfilled without this covering review.

SELECTION OF THE AUDITORS

The question then arises as to who shall be responsible for the selection of the auditing firm. Precedent has lodged this privilege in the board of directors, but there is now considerable discussion as to whether the right to choose should be placed in the hands of the stockholders. The practice is already a legal requirement in the state of Massachusetts and is commonly employed in England.[24] Some difficulties are inherent in the plan, particularly the procedure to be adopted in selecting a group by the stockholders who will be charged with the responsibility of naming the auditors. Several alternatives seem to be available. A vote by the stockholders may be taken at the time of the annual election, but the limitations and unwieldy character of this proposal are readily apparent. Another possibility is that of giving the power of selection to the larger stockholders, setting the minimum shareholdings large enough to prevent the group from becoming too large. Still a third plan would be to appoint an audit committee of "outside" directors for the purpose of making a "direct contact with the independent auditors."[25]

Irrespective of the procedure adopted to provide for an external audit, there is need to stress the importance of its adoption in practice. The relationship that exists in a large corporation between the stockholders and the directors is so remote that little weight may be attached to the historical and friendly ties which were presumed to exist between the two groups. Facing realities, directors of large corporations are necessarily far removed from the vast body of scattered stockholders; and they are motivated chiefly by their own personal sense of responsibility. This is cited not for purposes of condemnation but to point out that shareholders need to pursue a course that will also assure the maximum protection to their interests.

In setting up these checks upon management, the importance of high standards within the ranks of management should not be minimized. In fact, there is no better safeguard to investor interests than honest and

[24] Chap. 156, sec. 49, of the Annotated Laws of Massachusetts provides: ". . . , such auditor shall be selected and employed by a committee of three stockholders who are not directors, which shall be selected at the annual meeting of the stockholders. . . . If there are not three stockholders other than directors able and willing to serve on such committee, he shall be selected and employed by the directors . . . ; but no bookkeeper, treasurer or other officer of the corporation shall be appointed as such auditor."

[25] Sidney J. Weinberg, "A Corporation Director Looks at His Job," *Harvard Business Review,* September, 1949, p. 589. The author bases his recommendation, in part, on his experience as a director of McKesson & Robbins, Inc.

capable executive personnel. It is not easy for auditors to detect the beginnings of dishonest practice; and, of course, discovery always occurs after a certain amount of damage has already been done.

THE McKESSON & ROBBINS CASE

While the deficiencies revealed in the McKesson & Robbins case occurred more than two decades ago, it still serves as a forceful reminder of (1) the need to check management performance, (2) the importance of internal accounting controls, and (3) the need for thorough, external audit. In December, 1938, this company was placed in reorganization after it was reported that the assets had been overstated and the firm was probably insolvent. The company had a good reputation and did a large business manufacturing and wholesaling proprietary drug lines. It developed, however, that the crude-drug department, which had been under the sole direction and control of the president, F. Donald Coster, and the assistant treasurer, George E. Dietrich, was in reality a huge blind for illicit trading purposes. Over $10,000,000 in inventories charged to this department, as well as $9,000,000 in accounts receivable, were nonexistent. During the prohibition era, Coster and Dietrich had carried on a sizable bootlegging business and later had sold munitions to Spain under the guise of crude drugs. The "crude-drug" dealings had been carried on for years with W. W. Smith and Company, an English partnership, and with Manning and Company of Montreal, both of which proved to be mere shells.[26] Investigation also established that Coster and Dietrich were in reality Philip and George Musica and had been involved in fraudulent activities before.

The disclosure resulted from the discovery by the treasurer that there was no insurance on the crude-drug inventories. He inquired of Coster about the lack of insurance and was told that such insurance had been placed with W. W. Smith and Company. The treasurer had seen in the company's files several Dun & Bradstreet reports describing W. W. Smith and Company as a world-wide trading concern. Inquiry at the Dun & Bradstreet offices revealed the fact that the reports had not been issued by that firm and were forgeries.[27] The other concern with which Coster's department had had dealings, Manning and Company of Montreal, proved to be a small office with a single employee.

It is difficult to understand how such a fraud could have been continued for years without discovery if there had been an alert and inquiring management. However, Coster had been a smooth individual. He had taken over the crude-drug department from the beginning of his connection with the company, and he had kept this department strictly as his domain. The auditors had certified the crude-drug inventories on the

[26] *Moody's Manual of Industrials, 1939*, p. 2002.

[27] *Time*, December 19, 1938, pp. 48, 50.

basis of the certification of "responsible" officials. If the auditors had verified the inventories, or if the directors had acted on the one accusation leveled some years before, the fraud could have been terminated earlier.

In 1932, Waddill Catchings was appointed to head a special committee to study operations in an effort to bring about greater economies. He became convinced that the wholesaling operations were being managed properly, but he was unable to obtain any information whatsoever on the crude-drug operations. Convinced that something was wrong, Catchings wrote the directors to attend the April, 1934, meeting. Coster heard of his letter, hired a lawyer, and conducted a whispering campaign among the directors. As a result, the directors refused to act upon or investigate Catchings' report; consequently, the company was defrauded for another 4 years before the plot was discovered.[28] In fairness to the auditors, Price, Waterhouse and Company, who had done the auditing for the firm for 14 years, the audit was conducted in accordance with the authorization given. Also, the accounting practices followed were those used by a majority of the practicing public accountants. As a result of the revelations of the McKesson & Robbins fraud, the public accounting societies recommended the adoption of more extensive auditing procedures dealing chiefly with inventories and receivables. It is now a necessary part of an audit to verify the physical existence of inventories and to check receivables by direct communication with the debtors. If, for any reason, these steps are omitted, the fact of their omission is to be stated in the balance sheet rendered by the auditors.[29]

THE IMPORTANCE OF CONFIDENCE IN MANAGEMENT

Business activity cannot run smoothly without confidence and truthfulness. A board of directors must have confidence in its officers; but, at the same time, it is well to recognize the frailties of human nature. Every company should be so organized that all employees can be checked as to effectiveness and honesty. The auditors should not accept essential information year after year on the word of the officers concerned. And the board of directors should not permit extensive private operations on the part of its executive officers. Certainly, no corporation president should operate any portion of a company's assets without adequate and regular accounting for the results.

All of this is important not because of any abstract ideals of fair play but as a matter of practical business. Corporations must raise capital through the sale of stocks and bonds or other methods of borrowing; and the various sources of capital will hesitate to commit funds to the

[28] *Time*, January 9, 1939, pp. 48, 52.

[29] *United States of America before the Securities and Exchange Commission in the Matter of McKesson and Robbins, Inc., Report on Investigation* (1940), pp. 447 ff.

enterprise unless management is thorough, honest, and intelligent. Equally important is the probability that, over any long period of time, the honestly and efficiently managed concern will also be the most profitable one.

QUESTIONS AND PROBLEMS

1. Discuss the meaning of the term "management." Distinguish between its personal and functional connotations.
2. Discuss and evaluate the influence of changing economic and social conditions upon the concept of management.
3. Why are basic, underlying policies essential to effective practical operation of business enterprise? Give concrete examples of features that should be formulated into policies.
4. Give arguments for and against the legal requirement that decisions be made only by the board of directors as a whole.
5. Discuss the arguments for and against an "inside" board.
6. Evaluate the problems of directors becoming the "tools" of key management officials for (a) "inside" boards and (b) "outside" boards.
7. Consider the problems of assembling a board of directors for a specialized business, such as electronics.
8. "A corporation board of directors should include three interest groups. First, a few officers of the company. Second, a few stockholders—to give the investor's point of view. Third, a set of counselors of broad experience drawn from other fields who bring a wider horizon and tend to prevent a corporation from becoming too self-contained" (statement made by the president of Johns-Manville Corporation, *Business Week*, February 15, 1941, p. 28). Why would such a board be particularly fitting for the business of this corporation? Discuss the applicability of this principle elsewhere.
9. Which of the following bases of selecting board members do you prefer? (*a*) "We stress the importance of having each director engaged in a business which in no way duplicates the experience of another" (statement of the president of United Air Lines Transport Corporation, *Business Week*, February 15, 1941, p. 28). (*b*) "All directors are employees of the company, and in every instance have grown up through the organization, all of them having had many years of service" (statement of the president of the Standard Oil Company, *Business Week*, February 15, 1941, p. 28).
10. Newton D. Baker once observed that a director ought not to have stockholdings because the temptations were too great. He suggested that "an honest and fully disclosed profit-sharing scheme" is the best means of developing responsibility of directors. Discuss.
11. Evaluate the observation that the role of directors is enlarging, and note particularly the relationship to the democracy of capitalism.
12. Analyze the McKesson & Robbins case, and discuss the failure of the public accountants to make earlier discovery.
13. "At best, auditing uncovers deficiencies and wrong-doing only after the damage is done. It would be much more effective to have a system of internal checks and balances in the first instance to prevent their initiation. Prevention is necessarily better than cure." Discuss.
14. Discuss the problems that are likely to arise in connection with expense

accounts and in the mixing of personal items with corporate funds. Express your reaction to the facts shown on page 288.

15. Discuss the nature of internal auditing and its relationship to other operating departments.

REFERENCES

BAKER, J. C. *Directors and Their Functions.* Boston: Graduate School of Business Administration, Division of Research, Harvard University, 1945.

BLAIR, WILLIAM T. "Appraising the Board of Directors," *Harvard Business Review,* Vol. XXVIII, No. 1 (January, 1950), pp. 101–13.

BROEHL, WAYNE G., JR. "The Board of Directors in the Smaller Corporation," *Commercial and Financial Chronicle,* Vol. 189, No. 5822 (February 19, 1959), p. 22.

COPELAND, M. T., and TOWL, A. R. *The Board of Directors and Business Management.* Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1947.

DALE, ERNEST. "Management Must be Made Accountable," *Harvard Business Review,* Vol. XXXVIII, No. 2 (March–April, 1960), pp. 49–59.

GILBERT, LEWIS D. "Management and the Public Stockholder," *Harvard Business Review,* Vol. XXVIII, No. 4 (July, 1950), pp. 73–83.

MAURER, HERRYMAN. "The Age of the Managers," *Fortune,* Vol. LI, No. 1 (January, 1955), pp. 84–87, 122.

McDONALD, JOHN. "How Businessmen Make Decisions," *Fortune,* Vol. LII, No. 2 (August, 1955), pp. 84–87, 132–37.

MOORE, LEO B. "Too Much Management—Too Little Change," *Harvard Business Review,* Vol. XXXIV, No. 1 (January–February, 1956), pp. 41–48.

MYLANDER, WILLIAM H. "Management by Executive Committee," *Harvard Business Review,* Vol. XXXIII, No. 3 (May–June, 1955), pp. 51–58.

SMITH, E. EVERETT. "Put the Board of Directors to Work!" *Harvard Business Review,* Vol. XXXVI, No. 3 (May–June, 1958), pp. 41–48.

Stevens on Corporations, secs. 157, 159, and 160. St. Paul: West Publishing Co., 1936.

SUMMER, CHARLES E., JR. "The Managerial Mind," *Harvard Business Review,* Vol. XXXVII, No. 1 (January–February, 1959), pp. 69–78.

United States of America before the Securities and Exchange Commission in the Matter of McKesson and Robbins, Inc., Report on Investigation (1940).

WEINBERG, SIDNEY J. "A Corporation Director Looks at His Job," *Harvard Business Review,* Vol. XXVII, No. 5 (September, 1949), pp. 585–93.

Chapter 16 ►

ANALYSIS OF MANAGEMENT RESPONSIBILITIES

THE DISCUSSION in the preceding chapter was concerned mainly with the structure and form of management. There is need, however, to look behind the organization framework to inquire as to the responsibilities of management. Not only is this prompted by the need for orderly study of function, but in addition the developments of recent years have made the obligations of management a social issue. Such questions as the following are not uncommon: To whom is management responsible? What is the nature of its responsibility? What are the penalties for the neglect of responsibility? In seeking to answer questions of this type, a sharp distinction must be made between the legal, moral, and social responsibilities because only those of the first category have practical means of enforcement. We may begin our analysis with pertinent observations relating to the legal status of private management.

THE FIDUCIARY POSITION OF CORPORATE MANAGEMENT

As stated on another occasion, business management now faces a fundamental question of philosophy. To whom does it report? Obviously, its line of responsibility cannot end with itself, for the simple reason that it is justified neither by recognized organization pattern nor by its admitted obligations to the shareholders and the public. Under these conditions, its duties are largely of a fiduciary nature, i.e., the holding of a trust for others. From a strictly legal point of view, it is not surprising that the law minimizes the onus of social responsibility and treats directors mainly as standing in a fiduciary capacity to the body of shareholders and their interests.[1] The Sixth United States Circuit Court of Appeals in

[1] The general legal principle is stated in William Meade Fletcher, *Cyclopedia of the Law of Private Corporations* (rev. and permanent Ed.; Chicago: Callaghan & Co., 1931), Vol. 3, sec. 838, as follows: "Directors and other officers, while not trustees in the technical sense in which that term is used, occupy a fiduciary relation to the corporation and to the stockholders as a body." Commenting further, it

the case of *Ashman* v. *Miller*[2] commented upon the principle and its rationale as follows:

> A director of a corporation occupies a fiduciary relation to it and its stockholders. His position is one of trust and he is frequently denominated a trustee and so held accountable in equity. The ordinary trust relationship of directors of a corporation and stockholders is not a matter of statutory or technical law. It springs from the fact that directors have the control and guidance of corporate business affairs and property and hence of the property interests of the stockholders. Equity recognizes that stockholders are the proprietors of the corporate interest and are ultimately the only beneficiaries thereof. Those interests are in virtue of the law intrusted through the corporation to the directors and from that condition arises the trusteeship of the directors with the concomitant fiduciary relationship.

Rooted in this fiduciary relationship are two broad standards of conduct to which the law holds directors in their management of the corporation. These standards are (1) the highest fidelity to the interests of the corporation and (2) the discharge of their duties with reasonable care and reasonable prudence.[3]

FIDELITY TO THE INTERESTS OF THE CORPORATION

In applying the first of these broad standards of conduct to the decision of concrete cases, the courts have developed several well-settled rules which define the directors' duties and responsibilities arising from their fiduciary position. These rules may be stated briefly as follows: First, directors (and other officers as well) must exercise the utmost honesty in all transactions touching their duties to the corporation and its property, and all their dealings with and for the corporation must show the highest degree of good faith and fair dealing.[4] Second, directors must act for the benefit of the corporation and not for their own gain—they may not, directly or indirectly, derive any personal advantage or

---

is stated: "But whether or not directors and other corporate officers are strictly trustees, there can be no doubt that their character is that of a fiduciary so far as the corporation and the stockholders as a body are concerned. In other words, it is unquestionably true that, as agents intrusted with the management of the corporation, for the benefit of the stockholders collectively, they occupy a fiduciary relation, and in this sense the relation is one of trust."

[2] 101 Fed. (2d) 85, 90 (1939).

[3] A. A. Berle, Jr., and G. C. Means, *The Modern Corporation and Private Property* (New York: Macmillan Co., 1933), p. 221, state that the general rules of conduct which the law has developed are "(1) a decent amount of attention to business; (2) fidelity to the interests of the corporation; (3) at least reasonable business prudence."

[4] Fletcher, *op. cit.*, sec. 850, and cases there cited. *Globe Woolen Company* v. *Utica Gas & Electric Co.*, 224 N.Y. 483 (1918); *McMynn* v. *Richardson-Phenix Co.*, 186 Wis. 442 (1924). See also "Legal Safeguards about Transactions between a Director and His Corporation," *University of Pennsylvania Law Review*, Vol. LXXXIII (1934), p. 56.

profit which is not enjoyed in common by all the shareholders.[5] And, third, all secret profits made by directors in the transaction of the company's business or resulting from dealings in which their interest and the corporate interest conflict must be accounted for to the corporation.[6]

The variety of instances in the adjudicated cases of a breach by the directors of the fiduciary obligation implicit in the foregoing rules is without limit. A few examples will serve to illustrate the significance of the rules in practice. In a suit by a director against his corporation on a contract entered into by the two, the effect of which was to bring royalties to himself rather than to the corporation, the court refused to enforce the contract.[7] In another case, the board of directors authorized a sale of corporate property to the owner of the majority of the stock for an amount less than could have been obtained from another; the sale was held voidable at the instance of the minority stockholders.[8]

The situation has several times occurred where directors have exercised their power of control so as to divert to themselves unissued shares for which they pay the corporation par value and then resell to the public at a profit. The courts have held in such cases that the directors may be required to account to the corporation for the profit made[9] or may be compelled to surrender up the shares for cancellation.[10]

---

[5] *Jackson* v. *Ludeling*, 21 Wall. (U.S.) 616 (1874); *American Circular Loom Co.* v. *Wilson*, 198 Mass. 182 (1908); Fletcher, *op. cit.*, sec. 850, and cases cited there.

[6] Fletcher, *op. cit.*, sec. 850, and cases there cited; *Tenison* v. *Patton*, 95 Tex. 284 (1902); *Porter* v. *Healy*, 244 Pa. 427 (1914). The three general rules stated in the text were expressed as follows by the Supreme Court of Pennsylvania in the case of *Bird Coal & Iron Co.* v. *Humes*, 157 Pa. 278 (1893): "A director is a trustee for the entire body of stockholders, and both good morals and good law imperatively demand he shall manage all the business affairs of the company with a view to promote, not his own interests, but the common interests; and he cannot, directly or indirectly, derive any personal profit or advantage by reason of his position, distinct from his coshareholder. . . . And by assuming the office he undertakes to give his best judgment in the interests of the corporation in all matters in which he acts for it, untrammeled by any hostile interest in himself or others. There is an inherent obligation on his part that he will in no manner use his position to advance his own interest as an individual, as distinguished from that of the corporation. . . . And all secret profits derived by him in any dealings in regard to the corporate enterprise must be accounted for to the corporation, even though the transaction in which they were made also advantage the corporation of which he was director."

[7] *Farewell* v. *Pyle-National Electric Headlight Co.*, 212 Ill. App. 450, aff'd 289 Ill. 157 (1919). In its opinion, the court stated, among other things, that it is the duty of the directors "to administer the corporate affairs for the common benefit of all the stockholders, and exercise their best care, skill, and judgment in the management of the corporate business solely in the interest of the corporation. . . . they cannot have or acquire any personal or pecuniary interest in conflict with their duty as such trustees."

[8] *Wheeler* v. *Abilene Nat. Bank Bldg. Co.*, 159 Fed. 391 (1908).

[9] *Federal Reserve Life Ins. Co.* v. *Gregory*, 132 Kan. 129 (1931). In *Provident Trust Co.* v. *Geyer*, 248 Pa. 423 (1915), the directors were made to account for their profit for the benefit of those who had been shareholders of record at the time of the transaction.

[10] *Arkansas Val. Agr. Soc.* v. *Eichholtz*, 45 Kan. 164 (1891).

Situations involving interlocking directorates have caused the courts considerable difficulty for the reason that in such cases a director owes a double loyalty. The courts scrutinize contracts negotiated by corporations whose boards of directors have common members as carefully as they scrutinize dealings between a director and his corporation. They generally hold, where the fairness of such a transaction is challenged, that the burden of proof is upon those who would maintain the transaction.[11]

Other circumstances in which there may be a conflict of directors' interests are found where directors may use their knowledge of the corporation's condition and plans for the benefit of a rival business. Numerous cases are found which prevent a director from entering into such a competing business as would cripple or injure the corporation; and instruments or property that he has acquired for that purpose may be impounded for the benefit of the corporation.[12]

A commonly recurring situation calling for the application of the rules discussed above is one in which a director (or other corporate officer) acquires a title or interest adverse to that of the corporation while acting for the corporation or when dealing individually with third persons. In a case involving the stock of the du Pont Powder Company, the president, who was the largest stockholder, before leaving for an extended absence, offered to sell to the company a large block of stock at a certain price with a view to its resale at the same price to important employees. The Finance Committee of the company rejected the proposal solely because it thought the price was too high and instructed the acting president so to inform the absent president. The stock rapidly advanced in price because of World War I; and the acting president, by concealing important facts from the absent president and from the company (and while acting as a representative of the company), purchased the stock for himself and his associates. Funds and credit of the company were also used as an aid in financing the purchase, at a price considerably higher than that at which it was originally offered. The court held that the company had the right at its election to take over the stock purchased at the price paid and to require an accounting for all dividends received thereon. Among other things, it stated:

> When a director attempts in violation of his duty to acquire interests adverse to the corporation in respect to any matter involved in the confidence which has been reposed in him, as to which equity imposes a disability upon him to deal in his own behalf, the court will hold him as a trustee for the corporation,

---

[11] *Geddes* v. *Anaconda Copper Mining Co.*, 254 U.S. 590 (1921). For a case where such a transaction was voided, see *Corsicana Nat. Bank* v. *Johnson*, 251 U.S. 68 (1919).

[12] *Red Top Cab Co.* v. *Hanchett*, 48 Fed. (2d) 236 (1931); *Coleman* v. *Hanger*, 210 Ky. 309 (1925).

and he must account for the profits which otherwise would have accrued to the corporation.[13]

EXERCISE OF REASONABLE CARE AND PRUDENCE

The law, in holding directors to the second broad standard of conduct imposed upon them as fiduciaries, namely, the discharge of their duties with reasonable care and reasonable prudence, has developed the rule that they shall exercise such diligent care and skill as ordinarily prudent men would exercise under similar circumstances in like positions.[14] The rule was stated and its fiduciary content indicated by the New York Court of Appeals in the case of *Hun* v. *Cary*[15] in the following words:

> When one deposits money in a savings bank, or takes stock in a corporation, thus divesting himself of the immediate control of his property, he expects, and has the right to expect, that the trustees or directors, who are chosen to take his place in the management and control of his property, will exercise ordinary care and prudence in the trusts committed to them—the same degree of care and prudence that men prompted by self-interest generally exercise in their own affairs.

Application of the rule does not, of course, preclude delegation of certain duties to subordinates, since directors cannot be expected to supervise all the details of the corporate business. Yet, the right to delegate does not exempt the directors from the duty to check the conduct of their subordinates; nor does it free them of the necessity for exercising proper care in their appointment.[16]

DIRECTORS AND THE INDIVIDUAL STOCKHOLDER

Basically, the fiduciary line of relationship of management is to the corporation and to the stockholders as a group. However, there is also the practical question as to whether "a director can be honest and faithful with regard to the whole corporation at the same time that he is taking a hostile position towards an individual shareholder."[17] The Supreme Court of Georgia, in the leading case[18] on this question, which, incidentally, is a

---

[13] *du Pont* v. *du Pont*, 242 Fed. 98 (1917).

[14] *Stevens on Corporations* (St. Paul: West Publishing Co., 1936), sec. 146; the rule as stated in the text is also the substance of sec. 33 of the Uniform Business Corporation Act.

[15] 82 N.Y. 65, 71 (1880).

[16] See *Briggs* v. *Spaulding*, 141 U.S. 132 (1891); for a general discussion of the law on the subject of the standard of care and skill required in corporate management; see also C. Brewster Rhoads, "Personal Liability of Directors for Corporate Mismanagement," *University of Pennsylvania Law Review*, Vol. LXV No. 1 (1916), p. 128.

[17] Berle and Means, *op. cit.*, p. 222.

[18] *Oliver* v. *Oliver*, 118 Ga. 362 (1903).

minority view, answers it firmly in the negative.[19] In that case, the man who was both president and director of the corporation secured an option to purchase stock from certain stockholders at $110 per share. At the time the option was taken, a sale of the company's plant was contemplated at a price that would make the stock worth from $140 to $185 per share. This information was not disclosed to the selling stockholders; and, as soon as the sale of the plant was definitely completed, the director took up the option and made a substantial profit. The court allowed the stockholders who had sold him the stock to recover the profit made. The court, in the course of its opinion, commented as follows:

> And this brings us to a consideration of the relation which a director bears to an individual stockholder. All the authorities agree that he is trustee for the company, and in his capacity as such he serves the interests of the entire body of stockholders, as well as those of the individual shareholder, who usually cannot sue in his own name for wrongs done the company by the officer. . . . But the fact that he is trustee for all is not to be perverted into holding that he is under no obligation to each. The fact that he must serve the company does not warrant him in becoming the active and successful opponent of an individual stockholder with reference to the latter's undivided interest in the very property committed to the director's care. That he is primarily trustee for the corporation is not intended to make the artificial entity a fetish to be worshiped in the sacrifice of those who in the last analysis are the real parties at interest. No process of reasoning and no amount of argument can destroy the fact that the director is, in a most important and legitimate sense, trustee for the stockholder. . . . Not a strict trustee, since he does not hold title to the shares, not even a strict trustee who is practically prohibited from dealing with his cestui que trust, but a quasi trustee as to the shareholder's interest in the shares.

Commenting further, the court continued:

> It is conceded that the position which the director occupies prevents him from making personal gains at the expense of the company, or of the whole body of stockholders. But the rule that he is not trustee for the individual shareholders inevitably leads to the conclusion that, while a director is bound to serve stockholders en masse, he may antagonize them one by one; that he is an officer of the company, but may be the foe of each private in the ranks. When it is admitted, as it must be, both from the very nature of his duty, and from the rulings of nearly all the cases, that he is trustee for the shareholder, how is it possible, in principle, to draw the line, and say that, while trustee for some purposes, he is not for others immediately connected therewith? That the incidents

[19] Fletcher, *op. cit.*, sec. 1168. Of course, the director may not actively mislead the selling stockholder or perpetrate a fraud; *ibid.*, sec. 1172. The majority rule was expressed by the Supreme Court of Tennessee in *Shaw* v. *Cole Mfg. Co.*, 132 Tenn. 210 (1915), as follows: "While directors occupy a trust relation to the corporation which they direct, their duty does not apply to the stockholder in the sale and purchase of stock. Dealing in its own stock is not a corporate function. In buying or selling stock, directors may trade like an outsider, provided they do not affirmatively act or speak wrongfully, or intentionally conceal facts with reference to it." The rule has been followed in Arizona, California, Delaware, Illinois, Indiana, Kentucky, Louisiana, Massachusetts, Michigan, Minnesota, Missouri, New Jersey, New York, North Carolina, Pennsylvania, Tennessee, Utah, and Washington, and perhaps other states.

of the trust relation stop short at the very point where it is vitally important to the shareholder that they should become active? For it must not be forgotten that the right to good faith in dealings concerning the stock is one of the very few which the individual shareholder is in a position to assert in his own name. Except in a few other instances, the company itself is the only proper party to enforce the obligation arising from the trust relation of the director.

Courts adopting the majority view—that the fiduciary relationship exists only as between management and the corporation—commonly assert that the minority view assumes a personal relationship between a purchasing director and a selling stockholder which does not in most cases exist. They urge, in support of their position, that the purchase and sale of securities are ordinarily impersonal affairs effected on stock exchanges through brokers; that the actual buyer and the actual seller have no personal relationship, whatever; that each individually and without influence from the other determines his own course of action; that, therefore, it is absurd to insist that there is any such relationship, fiduciary or otherwise, between the parties as to justify an action by a stockholder against a director or an officer based on failure to disclose facts that might have affected the value of the stock.[20]

The Massachusetts court in the case of *Goodwin* v. *Agassiz*,[21] in refusing recovery by a suing stockholder, expressed its view on this point as follows:

Purchases and sales of stock dealt in on the stock exchange are commonly impersonal affairs. An honest director would be in a difficult situation if he could neither buy nor sell on the stock exchange shares of stock in his corporation without first seeking out the other actual ultimate party to the transaction and disclosing to him everything which a court or jury might later find that he then knew affecting the real or speculative value of such shares. Business of that nature is a matter to be governed by practical rules. Fiduciary obligations of directors ought not to be made so onerous that men of experience and ability will be deterred from accepting such office. Law in its sanctions is not coextensive with morality.

TRENDS IN RECENT TIMES

Legal developments in recent times point to the imposition upon directors of an increasingly more exacting fiduciary duty. In most cases where the question of a director's fiduciary capacity has arisen, the courts have simply imposed a standard of conduct which prohibits a director from obtaining personal gain from a transaction to the injury of the corporation—a negative type of duty.[22] However, in the case of *Bodell* v.

[20] This is the position regarding exchange transactions taken in R. Walker, "The Duty of Disclosure by a Director Purchasing Stock from His Stockholders," *Yale Law Journal*, Vol. XXXII (1923), p. 637.

[21] 283 Mass. 358 (1933).

[22] See Note, *Iowa Law Review*, Vol. XX (1935), p. 808.

General Gas & Electric Corporation, the court talked in its opinion of a more positive type of duty.[23] In holding directors as trustees of unissued stock, the court declared that it was not always necessary for them to reap personal benefit "in order for their actions in performance of their quasi trust to be successfully questioned." The court even went so far as to say that the directors as trustees "owe not alone the duty to refrain from benefiting themselves at the expense of their beneficiaries," but also owe "the duty of saving their beneficiaries from loss." By "beneficiaries," the court was of course referring to the stockholders. Further evidence of the tightening of the fiduciary position of directors is found in the tendency of some courts, particularly in the western states where the law relating to trusts has been codified, to apply to directors the statutory rules governing ordinary trustees.[24]

The accountability of directors for negligence or other mismanagement has also received increased attention in keeping with modern trends:

> Although, nominally, the standards of conduct enunciated by the courts in recent years are the same as they were a half century ago, it is evident from the decisions that the courts are, in fact, holding the directors accountable for a higher degree of care, diligence and judgment than did the courts which first announced the very rules which are being applied today. It is no longer possible for a director, who has been little more than a figurehead, to escape liability for the consequences of his negligence by pleading, when called to account for his dereliction, that he has acted honestly and in good faith.[25]

The trend toward enforcement of a more positive fiduciary duty upon directors has received its chief impetus, however, not from court decisions but from legislative enactments arising out of the depression of the thirties. Heavy losses by investors served to dramatize their plight and created popular pressure for protective measures. In turn, much of the impact of New Deal legislation in the field of corporation law appears to have fallen most heavily on corporate directors. This may be partly attributed to a rather substantial reaction against the prevalence of "directors who do not direct."[26] This newer attitude has manifested itself primarily in a tendency to require of directors adequate knowledge of the affairs of the corporation they direct and to hold them liable accordingly.

[23] 15 Del. Ch. 119 (1926), aff'd 15 Del. Ch. 420 (1927).

[24] Fletcher, *op. cit.*, sec. 840; see, e.g., *North Confidence Mining & Development Co.* v. *Fitch*, 58 Cal. App. 329 (1922), in which the court stated: "Directors of a corporation are trustees thereof within the meaning of section 2230 (one of the provisions of the California Code applicable to technical trustees)."

[25] "Liability of Directors for Negligent Mismanagement," *University of Pennsylvania Law Review*, Vol. LXXXII (1934), pp. 364, 368.

[26] William O. Douglas, "Directors Who Do Not Direct," *Harvard Law Review*, Vol. XLVII, No. 8 (June, 1934), p. 1305.

REACTION OF DIRECTORS TO INCREASED LEGAL LIABILITY

Consideration may now be given to the response of directors themselves as the parties directly affected by the sharpening of responsibility. Many have expressed formal commendation of recent trends, but others believe that the added restrictions constitute unwarranted curtailment of private rights and interests. The opponents say, in brief, that to make public trustees out of private directors is unrealistic and impractical. On the first count, they see little incentive or reason (let alone legal right) for private directors to become public servants; in fact, they believe their most effective public service is to keep their own house in order. As to the second point of impracticability, they believe that the increased legal liability of a position as trustee would cause many outstanding people to refuse to serve as directors. Particularly is this true, it is contended, when directors now receive only nominal fees or minimum compensation. Also, it is believed that the part-time service of directors makes it impossible for them to have sufficient familiarity with operations to justify the greater responsibility.

LEGAL MEANS OF AVOIDING LIABILITY

Undoubtedly, the Securities Act of 1933 and the Securities Exchange Act of 1934, discussed at length in Chapters 20 and 21, respectively, gave new emphasis to the liabilities of directors. In any event, there developed in the early forties a trend toward the adoption of statutory and bylaw provisions which would indemnify directors for expenses incurred by them in the defense of lawsuits.[27] In the case of a bylaw amendment, the stockholders authorize the corporation to reimburse the directors or officers for the costs and expenses of legal actions which involve them because of their position. The following is reported to be typical of the provisions providing for relief:

> The corporation shall reimburse any officer or director, whether or not then in office, for the reasonable costs and expenses incurred by him in the defense of any claim or action against him by reason of any act or omission to act as an officer or director of the corporation, provided that such officer or director shall not have been derelict in his duty with such act or omission to act.[28]

Statutes were also enacted in various states to permit the indemnification of directors and officers. In some states, the provisions were set forth in general terms; in others, indemnification was authorized if the charter or bylaws so provided; and in still others, it was made a function of the

[27] See Ganson Purcell, Roger S. Foster, and Alfred Hill, *Corporations: Enforcing the Accountability of Corporate Management and Related Activities of the SEC* (New York: Practising Law Institute, 1946), pp. 17–25.

[28] *Business Week*, February 15, 1941, p. 26.

courts.[29] As a matter of general policy, the Securities and Exchange Commission is opposed to these various measures of indemnification; but its authority is necessarily limited to the powers contained in the various acts which it administers. As stated elsewhere, the latter stress the full disclosure of material facts affecting security issues and do not provide for the regulation of corporate policies.[30] Also, it should be stated that indemnifying provisions could not apply where officers and directors are guilty of negligence or misconduct.

MORAL RESPONSIBILITY OF OFFICERS AND DIRECTORS

One of the new words coined in recent years is "payola"; in essence, it is used to give expression to conditions where a single person takes advantage of his multiple interests in a transaction. While the practice has been given greatest publicity in the radio and television fields, it involves a principle that is quite common throughout industry generally. In brief, the basic question concerns the propriety of self-dealing. Often it may be legal, but the morality of the practice is on trial before the bar of public opinion.

Those who defend self-dealing commonly do so on the grounds that there are mutual, or even special, benefits to both parties of interest. The point at issue may be made clear by the actions of the then president of the Chrysler Corporation, which came to light in the year 1960. Supplies for Chrysler had been purchased from a company in which the president of the former had a stock interest. The defense was a familiar one—the price was as low or lower than that which would exist on the open market. However, who can prove that other independent officers could not have obtained a lower price, even from the same source of supply? In any event, the contention was made that any gains accruing to the personal benefit of the president were not at the expense of the Chrysler Corporation.

We need not concern ourselves with the several court cases initiated in connection with the Chrysler incident, because even these cannot resolve the true essence of the problem. The propriety of business conduct can never be determined by legal decision alone; in addition, there is needed a code of ethics or morality if public confidence is to be assured. Granted that such a code can never be reduced to terms that are universally acceptable, even so, individual actions will always be appraised in the light of such criteria. And, in the long run, it is likely that private enterprise will endure only by meeting moral standards that are generally recognized as fair and proper.

Where self-dealing exists, a vital feature of evaluation of the conduct

---

[29] Purcell, Foster, and Hill, *op. cit.*, p. 18.

[30] See p. 398 for an example of language required in registration statements covering new security issues.

is automatically eliminated—the test of arms' length bargaining. Participants may proclaim the benefits to all parties of interest, but their opinions are obviously clouded by the lack of objectivity of view. In the Chrysler case, the president was promptly discharged from his office by the directors.

Whether or not the courts will condemn the action remains to be seen, but the duty of directors to recognize the moral aspects of business transactions is clearly established. At the same time, it is appreciated that appraisal of any moral action will vary according to personal opinion, and we pose the problem as an emerging issue in the new and changing order of business conduct.

SOCIAL RESPONSIBILITY OF DIRECTORS

The control of social well-being exercised by business as a whole is to a great extent an inevitable part of its operations. Consumers are affected by the prices they pay, and wage earners prosper or suffer according to the opportunities for employment. Irrespective of the means of control used for business as an institution, the process would exert large influence over our daily lives. Since such influence is inherent, one may be inclined to follow the sage advice of the philosophical deacon who exhorted his followers to "make peace with the inevitable." On the other hand, there is increasing consciousness of the social responsibility which attaches to directors; and the thought is quite commonly accepted that profits must be "considered in the broadest sense with due regard to the public interest."[31]

In appraising the social responsibility of directors, it is necessary to realize that, by its very nature, this responsibility is largely of an intangible character and is not even subject to the yardstick of legal precedent. Also, it is the result of the changing public outlook which followed the crash of 1929 and the subsequent depression. Usually, somebody is blamed for such catastrophes; and, in this instance, political conditions were of a nature to bring the difficulties into focus. When studied on the basis of calm deliberation, it must be apparent that such a broad and generalized conclusion must fail to reflect the more important unsettled world conditions. However, there can be no escape of business from accountability for the results and from the increased public responsibility.

NATURE OF PUBLIC TRUSTEESHIP OF CORPORATE MANAGEMENT

In applying this broader concept of trusteeship to corporate management, it must be recognized that much of the thinking at this stage is

[31] J. C. Baker, "The Board of Directors—Duties and Responsibilities," *Dun's Review*, February, 1946, p. 15.

ideological in character. It is an objective that has social glamour but is not so easily put into practical operation. Being an intangible force, its strength is found more in intent and spirit than in prescribed rules of conduct and in specific tests of measurement. In many respects, the doctrine of trusteeship is intended to apply to the individual directors; but there is also a broader applicability as a force underlying the formulation of board and industry policies.

While recognizing the intangibility of trusteeship, it must be apparent that its application to practical affairs must be specific. Only by this means can true substance be provided. The sharpening of the sense of trusteeship may come about as a result of enlightened business leadership, or it may be compelled by the pressure of public opinion. Already, many business leaders are giving expression to the thought. The following comment reflects the expediency of its adoption irrespective of ethical considerations: "Our company needs a public utility philosophy; if it doesn't get one it will become a public utility."[32]

A well-known business leader said as early as 1931: "It makes a great difference in my attitude toward my job . . . whether I am a trustee of an institution or an attorney for the investor."[33] Moreover, there was cold realism underlying this expression of attitude because he wanted his company to be able to attract the best laborers, to secure public preference for the company's products, and to command public confidence so that capital would be available when needed.

Reflecting a larger cross section of business opinion, the editors of a well-known business journal "contend that a fundamental change in attitude among businessmen has taken place in the last few years . . . and that . . . many . . . believe, accept and advocate social responsibility."[34] There is always danger of inaccuracy in reporting composite opinion, but there can be little doubt that the uncertainties of economic trends and the repercussions of international conditions have had a profound influence upon business philosophy.

Today, there is wide acceptance of the practical implications of the social responsibility of corporate management. In part, it is the result of compulsory response to legal requirements but, in addition, many business leaders are voluntarily promoting the concept as a matter of good business sense. For example, in the annual report of the Crown Zellerbach Corporation for the fiscal year ended April 30, 1955, the president of the company declared:

[32] Temporary National Economic Committee, *Bureaucracy and Trusteeship in Large Corporations* (Monograph No. 11 [Washington, D.C.: U.S. Government Printing Office, 1940]), p. 109.

[33] *Ibid.*, p. 109; and also see the source of original quotation, *Fortune*, March, 1931, p. 94.

[34] Temporary National Economic Committee, *op. cit.*, p. 120, as based upon an article entitled "Business and Government," *Fortune*, March, 1940, pp. 38–39.

> We believe that industry today has acquired a quasi-public character. The days of the industrial tycoon are gone. Corporations are being run by professional managers on behalf of public owners—the stockholders. Crown Zellerbach started as a family business, but has become a public business with some 22,000 share owners. Moreover, a considerable portion of our stock is held by insurance companies, pension funds, and personal and investment trusts . . . . so that we are indirectly owned by, and responsible to, millions of people. Beyond this, we also have far-flung responsibilities to many thousands of employees, suppliers, customers and citizens in the communities where we operate. All of these people are important to us, for their confidence and support are indispensable to our success.[35]

Even though it is difficult to make precise measurement of the application of belief, nevertheless, there can be no denial of its influence. Probably more than we realize, the declaration of policy or philosophy is but the prelude to slow, but inevitable, changes in the *modus operandi* of both personal and business conduct.

INFLUENCE OF PUBLIC OPINION

In addition to enlightened business leadership, a second factor which will help to mold and determine the qualitative nature of trusteeship is public opinion. As long as freedom of individual action was held in high public esteem, business was able to function with a minimum of public interference. A shift in public approbation will automatically compel social institutions to revise their code in order to comply with the public will. This force normally accumulates momentum slowly; but, in periods of emergency, it can be surprisingly cataclysmic in action. Thus, in the decade of the thirties, the severe depression of business activity produced a vigorous response in the way of public reaction. Even in normal periods, the power of community standing and prestige is well-recognized as a governor of individual action. In this connection, the following comment, made in 1927, is of interest:

> If the community gets this social point of view, if it rather questions mere money-making, if money-making without social standards is frowned upon, and if real social accomplishment is esteemed . . . we shall get the real leaders in a sufficient number, because it is the approval of the tribe that determines the types of leadership exercised by its leaders.[36]

As indicated above, the force of public opinion "accumulates momentum slowly" but, ultimately, it brings about the acceptance of many ideas and practices that were earlier considered to be inconsistent with our pattern of society. It is for this reason that private business, today, is

[35] J. D. Zellerbach, President, Crown Zellerbach Corporation, *Annual Report for the Year Ended April 30, 1955*, p. 1.

[36] Temporary National Economic Committee, *op. cit.*, p. 123, quoting from Wallace B. Donham, "The Professional Side of Business Training," in *Business Management as a Profession*, edited by Henry C. Metcalf (Chicago: A. W. Shaw Co., 1927), chap. xiii, pp. 228–29.

putting into effect as a matter of course many features of operation that would have been considered revolutionary a quarter of century ago. But public opinion is a continuing and ruling force—however slowly, it does convert expressions of philosophy into the manifestations of practice. In turn, as a practical matter, business leadership accepts the ultimatum and conducts its operations accordingly.

PRACTICABILITY OF TRUSTEESHIP MOTIVE

The specific and practical enforcement of the responsibilities of trusteeship in its larger sense is no simple accomplishment. Enlightened business leadership and the power of public opinion will do much to establish it as an objective of business operation, but there is always the likelihood that actual performance will be something less than the ideological standard. Thus, one writer has observed that "a critical examination of the nature of the legal principle involved—loyalty to stockholders—tends strongly to dispel any high degree of optimism with regard to the future."[37] Similarly, it is contended that "the difficulty which we are discussing, of producing a strong emotional response to the law of fiduciary obligations, is not confined to corporate capitalism but is inherent in all large-scale enterprise, whether its form be capitalist, socialist or something else."[38]

It will be noted that the observations cited above relate primarily to the incentive of "loyalty to stockholders" as a means of cultivating a more profound sense of trusteeship. There is admission that other larger incentives may be more effective, but it is held that "profit-making for absentee owners must be the legal standard by which we measure the directors' conduct until some other legal standard has been evolved."[39] In similar manner, Adam Smith said long ago: "The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own."[40]

Extreme pessimists see little opportunity for any widespread acceptance of the trusteeship principle until human nature is changed. This is, indeed, a familiar argument which is commonly applied against any form of social progress. Obviously, it is not subject to specific or empirical

[37] E. M. Dodd, Jr., "Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?" *University of Chicago Law Review*, Vol. II (1935), p. 200.

[38] *Ibid.*, p. 202, where the writer recognizes this argument against his emphasis upon "vicarious acquisitiveness" as a motive for capitalistic operation. However, he answers, in part, by pointing out that state socialism, consumer co-operatives, etc., have an ideal other than acquisitiveness.

[39] *Ibid.*, p. 206.

[40] Adam Smith, *The Wealth of Nations* (1776; Everyman's Library Edition), Vol. II, p. 299.

refutation. At the same time, contrary opinions rest on equally sound ground and may often be supported by long-term observation of the course of human affairs. For example, the subsidence of individual aggrandizement is often found in times of dire emergency. Bombings of large cities in World War II reflect the application of this thought to physical distress; analogously, the economic difficulties of the thirties and the current pressures of international problems may likewise serve as a stimulus to change in the form of the business system.

SUMMARY COMMENTS

For purposes of both summary observation and clarity of understanding, we may bring into focus the differences in the concepts of trusteeship as used throughout this chapter. The legal connotation holds that the fiduciary character of a director's position is limited to relationships between the director and the corporation and the body of stockholders. As pointed out earlier, the liability arising because of this status is usually subject to minimum rather than maximum accountability. It should be stressed that this is the type of trusteeship which is applicable in business practice because it alone is subject to legal enforcement.

The two other concepts of trusteeship—moral and social—are more general and are likely without support of legal sanction on any broad scale. Indeed, it is conceivable that there may be such a condition as "legal larceny"—at least in the minds of neutral observers if not of the parties to the act in question. The "practicalities" of such actions may be stressed by the interested participants but, in the long run, moral and social concepts often mold the ultimate shape of the pure legalities.

Involved is the familiar conflict between idealism and realism. In our opinion, however, private business would be unrealistic in not recognizing the enlarging sense of public responsibility being attached to directorships of private corporations, and particularly those of considerable size. The altruistic approach can, of course, be unduly extended, and the true answer can only come from a reasonable balancing of the public and private duties of directors. In turn, this will take form only by the exercise of the qualities of statesmanship which all too frequently are associated only with public affairs; but, today, "private statesmanship" and leadership are also vital to the continued well-being of our economy, let alone the particular enterprises under private management.

QUESTIONS AND PROBLEMS

1. Discuss the influence of underlying business philosophy upon corporate management.
2. "The first duty of directors is to consider economic conditions and trends, and to chart the policies that the association is to pursue. The second responsibility is to engage a qualified and capable managing officer to adminis-

ter these policies. Let the directors define the policies—let the manager do the work" (statement made by the president of the Railroad Federal Savings and Loan Association of New York, *Business Week*, February 15, 1941, p. 28). What are the difficulties of putting such a program into operation? Discuss the merits of this statement.

3. "A board of directors . . . should also consider carefully the effect of its operations upon our national economy and the welfare of the nation at large. There is a real need in business for men with a broad experience in current sociological problems as well as administrative ability." (This statement was made by the chairman of the board, Freeport Sulphur Company, *Business Week*, February 15, 1941, p. 28.) Discuss the merits of this suggestion. Review the composition of the board of directors of this company and show the connection of each director.
4. Evaluate the two commonly accepted standards of the conduct of directors: (*a*) that a director should not accept risks for others that he would not take with his own funds, and (*b*) that a director should do what "ordinarily prudent men" would do under similar circumstances.
5. Do you think that honest delegation of authority should relieve a director of his responsibility?
6. During the period from November, 1929, through November, 1935, the Hupp Motor Car Company suffered losses of about $14,000,000; annual salaries through 1934 were paid as follows:

Year	President	Chairman of Board	Three Vice-Presidents and Members of Executive Committee (Each)
1929	$150,000	$50,000	$25,000
1930	150,000	50,000	25,000
1931	150,000	50,000	25,000
1932	139,500	33,333	.....
1933	88,333	17,416	.....
1934	......	33,666	....

Salaries of the general sales manager, production manager, chief engineer, treasurer, etc., were scaled proportionately (see Securities and Exchange Commission, *Decisions*, Vol. I [Washington, D.C.: U.S. Government Printing Office, 1938], pp. 177–201, for full details). Express your opinion of the financial and moral merits of such payments to officers in the face of the poor earnings record.

7. Do you think that directors and officers should speculate in the stock of companies with which they are connected?
8. Discuss the problem of self-dealing and the difficulties of restraining its practice.
9. Assume that the lowest price of three open competitive bids exceeded the price offered by a company with a stock interest held by the president of the prospective buying corporation: (*a*) Discuss the features which would be involved in deciding which bid to accept. (*b*) Would you accept the lowest price irrespective of stock relationships?
10. Do you think that disclosure of interlocking relationships would make self-dealing proper?
11. What would be the difference in the attitude of a director who considered

himself "a trustee of an institution" as compared with one as "attorney for an investor"?

12. Discuss and evaluate the influence of public opinion upon the policies and practices of private business operation.
13. Do you think that directors are or should be motivated by "vicarious acquisitiveness"? Do you think it can be avoided?
14. Express your opinion of the amendment of bylaws to protect directors against loss so as to relieve them from personal responsibility.
15. Comment on the observation that "the difficulty . . . . of producing a strong emotional response to the law of fiduciary obligations, is not confined to corporate capitalism but is inherent in all large-scale enterprise, whether its form be capitalist, socialist or something else."

REFERENCES

BERLE, A. A., JR. "Corporate Powers as Powers in Trust," *Harvard Law Review,* Vol. XLIV, No. 7 (May, 1931), pp. 1049–74.

BERLE, A. A., JR. and MEANS, G. C. *The Modern Corporation and Private Property,* chap. v. New York: Macmillan Co., 1933.

BOWEN, HOWARD R. *Social Responsibilities of the Businessman.* New York: Harper & Bros., 1953.

DALE, ERNEST. "The Social and Moral Responsibilities of the Executive in the Large Corporation," *American Economic Review,* Vol. LI, No. 2 (May, 1961), pp. 540–48.

DODD, E. M., JR. "For Whom Are Corporate Managers Trustees?" *Harvard Law Review,* Vol. XLV, No. 7 (May, 1932), p. 1145.

DOUGLAS, WILLIAM O. "Directors Who Do Not Direct," *Harvard Law Review,* Vol. XLVII, No. 8 (June, 1934), pp. 1305–34.

NORRIS, LOUIS WILLIAM. "Moral Hazards of an Executive," *Harvard Business Review,* Vol. XXXVIII, No. 5 (September–October, 1960), pp. 72–99.

Stevens on Corporations, chap. xvi. St. Paul: West Publishing Co., 1936.

TEMPORARY NATIONAL ECONOMIC COMMITTEE. *Bureaucracy and Trusteeship in Large Corporations.* Monograph No. 11, Washington, D.C.: U.S. Government Printing Office, 1940.

PART IV ►

Sale and Regulation of Securities

Chapter 17 ►

SOURCES OF CAPITAL

CUTTING SHARPLY through the dogma of finance is the cold reality of actually raising the funds. Without success on this count, corporate securities are only legal abstractions; and the capitalization is simply a blueprint of financial planning. Stated bluntly, the real job is to attract other people's money. It is true that the earnings of a well-established company may provide for a large measure of its needs; but, even so, continued carrying of the existing capital is still essential. More obvious is the need for additional capital to finance the expansion programs of going concerns and the development of new enterprise. In short, there is no escape from the compelling fact that the corporation is almost wholly dependent upon people investing their savings either directly or indirectly in industry.

THE LARGER BACKGROUND

Looking to the more basic factors which underlie savings and the supply of capital, it should be stressed that much depends upon general economic conditions as well as the state of national development. Prior to World War I, the United States was usually a debtor nation; and our domestic supply of capital was supplemented by investments from abroad. Under these conditions, there was a race for capital; and the resulting high rates of return necessarily added to the costs of corporate financing. Since this earlier period, the United States has largely played the role of a creditor nation. This status has been under pressure during the past two or three years but, in the main, capital has been comparatively cheap, and corporations have had minimum difficulties in obtaining funds.

Despite the abundance of capital in this country, a condition of relative scarcity quite commonly makes its appearance in periods of business adversity. Capital goes into hiding, the increments of supply are inadequate to take care of new demands, and the important undertone of confidence is missing. These were the characteristics of the early thirties which froze the capital market and demoralized business generally. As a

result, there developed an attitude on the part of investors which even today is casting its shadow upon the investment of funds. In brief, individual investors all too frequently want virtually 100 per cent liquidity and are reluctant to make strictly long-term commitments. It is true that bonds with long maturities and stocks in perpetuity are currently being sold in large volume, but there is an eye to their marketability as well as concern for their safety.

Individual savers look to various types of financial institutions to give them the qualities they seek and are content to accept a lower rate of return. As a result of these conditions, institutional investors have become much more important as a source of capital funds than was true in earlier years. Prior to the thirties, capital was raised mainly by the sale of securities to the public, known as a public offering. Since that time, securities have been commonly sold directly to one or a limited number of institutional investors; also, there may be co-operative arrangements in which the banks take the shorter maturities of serial or term loans while the insurance companies buy the longer maturities, or the latter may issue a commitment to take over the obligations after a stated period of time. Transactions of this type are known as private or direct placements of securities.

In the twenties, the private placement of new security issues lacked sufficient volume to warrant separate reporting; but now, as may be seen in Table 29, it accounts for a representative proportion of the total financing. Undoubtedly, institutional investment may tend to equalize the bargaining position of capital supply and demand, although there is still the need to recognize that the keystone is the savings of individuals. Financial institutions may assume some of the direct responsibilities which were previously placed on the shoulders of industry; but, at the same time, corporate management should never lose sight of the ultimate source of capital.

CHANGING MONEY AND CREDIT CONDITIONS

The availability of capital is affected not only by changing business conditions but is also subject to trends relating to money and credit specifically. Normally the term "money market" is used to refer to short-term credit, such as commercial paper and government bills; and the term "capital market" is used to designate activities in long-term credit, which is characterized mainly by securities of the investment type. But there is such interaction between these two segments of finance that the money market is often regarded as a composite of all the forces bearing upon money and credit generally. Our reference to the money market here is mainly in connection with its influence upon investment capital, but the context should make the meaning clear.

The most important index of money-market conditions is the interest

rate, which, in turn, has an influence on the cost of raising funds by corporations. Interest rates also reflect capital supply and demand conditions. It is for this reason that the money market is followed carefully by those concerned with investment credit. In earlier years, interest rates were mainly a product of a free market; but, in recent times, the federal gov-

TABLE 29

CORPORATE PUBLIC OFFERINGS AND PRIVATE PLACEMENTS
1934–60*
(Amounts in millions of dollars)

Year	Public Offerings			Private Placements			Private Placements as Per Cent of Total Offerings	
	All Issues†	Debt Issues	Equity Issues	All Issues†	Debt Issues	Equity Issues	All Issues	Debt Issues
1934–37								
High	$4,199	$3,660	$ 688	$ 387	$ 385	$ 4	23.2	24.7
Low	305	280	25	92	92	...	8.2	9.2
1938–41								
High	1,912	1,628	284	813	811	7	32.6	35.5
Low	1,458	1,276	110	692	691	1	28.6	31.8
1942–45								
High	4,989	3,851	1,138	1,022	1,004	18	39.5	44.8
Low	642	506	136	372	369	3	17.0	20.7
1946–49								
High	4,983	3,019	1,963	3,087	3,008	88	43.6	50.4
Low	3,550	2,437	1,028	1,917	1,863	49	27.8	38.2
1950	3,681	2,360	1,321	2,680	2,560	120	42.1	52.0
1951	4,326	2,364	1,962	3,415	3,326	88	44.1	58.4
1952	5,533	3,645	1,888	4,002	3,957	45	42.0	52.1
1953	5,580	3,856	1,725	3,318	3,228	90	37.3	45.6
1954	5,848	4,003	1,844	3,668	3,484	184	38.5	46.5
1955	6,763	4,119	2,644	3,477	3,301	176	34.0	44.5
1956	7,053	4,225	2,827	3,886	3,777	109	35.5	47.2
1957	8,959	6,118	2,841	3,925	3,839	86	30.5	38.6
1958	8,068	6,332	1,736	3,490	3,320	170	30.2	34.4
1959	5,993	3,557	2,436	3,755	3,632	122	38.5	50.5
1960 (first six months)	3,108	2,009	1,098	1,696	1,592	104	35.3	44.2

* Source: Securities and Exchange Commission, *Twenty-sixth Annual Report for the Fiscal Year Ended June 30, 1960* (Washington, D.C.: U.S. Government Printing Office), p. 244.

† Amounts for summarized periods, 1934–49, may not equal sum of debt and equity issues because of difference in high and low years for these issues.

ernment has played an increasing role in influencing or regulating money-market conditions. As a result, there may be prolonged periods of stability; again, there may be quick changes in policy. Evidence of the latter became very clear in late 1947 and early 1948 when, at one stage, the Federal Reserve banks were forced to buy market offerings of federal issues approximating $1,000,000,000 in two days. The annual yield on

United States government obligations with a maturity of 15 years and over increased from an average of 2.19 per cent in 1946 to 2.44 per cent for the week ended March 27, 1948. During the same period, the average yield on high-grade corporate bonds increased from 2.44 per cent to 2.80 per cent. A more profound change occurred in March, 1951, when the government revised its policy of buying bonds to keep the price of long-term bonds at par or better. To note the effects, it may be observed that the average yield on long-term government bonds increased from 2.39 per cent in January, 1951, to 2.63 per cent in May, 1951; for the same period, the average yield on high-grade corporate bonds increased from 2.64 per cent to 2.89 per cent. Still more recently, in 1959, there were even sharper changes in money-market conditions; for dramatic evidence, we may recall that in October of that year the government issued intermediate-term obligations (4 years, 10 months' maturity) bearing a rate of 5 per cent. There was widespread encouragement of investment by individuals, and the success of the flotation caused the issue to be termed the "magic 5's." But probing beneath the popularity of these securities, we should note that the average yield on comparable term "governments" in January of 1959 was 3.86 per cent. During the same interval the average yield on high-grade corporate bonds rose from 4.12 per cent to 4.57 per cent. Since that time the money market has strengthened and, as of the close of 1960, the average yields on long-term government and high-grade corporate bonds were 3.88 per cent and 4.35 per cent, respectively.

The changes in bond yields may appear to be small in a mathematical sense, but we should not be unmindful of both their aggregate economic and symbolic meaning. In the economic arena, yields not only are the result of the cumulative influence of the past but, even more important, they may have a vital bearing on future developments. The cost of money is a prominent factor in decisions by management as to whether or not operations should be expanded, and a small differential may have significant marginal influence upon financial planning. In larger measure, investment returns give expression to the "tone" of the market and, in this sense, their symbolism may mean much to the long-term outlook. The bond market and the stock market alike may develop an atmosphere of uneasiness which can well impede the flow of capital. As a result, the assurance that is so vital to the sale of new securities may be weakened; indeed, changes in yields have undoubtedly played a part in the familiar recessions of the past decade.

THE TYPE OF SECURITY OFFERED

An important conditioning factor which has marked effect upon the sources of funds is the type of capital which may be required. Although any rigid classification of risk is impossible, a distinction may be drawn

between stocks and bonds. Investment in the former is made with full knowledge that all the risks of residual ownership are being assumed. Both legislative prohibition and the expected responsibilities of trusteeship prevent most types of financial institutions from making this form of investment on any large scale, and there is more than the usual dependence upon individuals as a source of funds. Occasionally, proposals are advanced for special governmental accommodation of new and small enterprises; but such measures only emphasize the more deep-seated causes which prevent the attraction of capital on a voluntary basis.

In contrast, it is less difficult to raise capital by the sale of bonds because of the greater emphasis which may be placed on the safety factor. Most people, along with financial institutions, quite properly regard the security of their investment as the primary requirement and demand proof of its existence. It is for this reason that new concerns find it more difficult to raise funds than established companies which are able to support their claims with a record of performance. Even in periods of severe depression, companies of recognized strength are able to float securities successfully, although they are compelled to offer a higher rate of return. Underneath it all, the real problem of attracting any form of capital is the provision of an inducement that gives reasonable promise of offsetting the inevitable risks. Prior to the thirties, it was assumed that this was strictly a matter of decision by a free market; today, the backing of governmental credit or regulation is often regarded as a necessary form of secondary protection.

SIZE OF THE BUSINESS

Another condition affecting the raising of funds is the size of the business. For the most part, small enterprise raises its capital from an unorganized market (however, later in this chapter attention will be given to special government facilities). Even as a matter of normal policy, there is apt to be considerable temporizing by small companies in their financial planning. Loans with insufficient maturities may be obtained from commercial banks mainly because of their immediate availability. Again, the reluctance of local management to share either control or profits with outsiders may encourage the acceptance of investments with terms that are out of harmony with the flow of business operations. But, clearly, the most significant deficiency of all is the limitation that results from size itself. In keeping with its environment, the small company must generally look to local sources for capital and finds its opportunities restricted accordingly.

Unlike small business enterprises, large business institutions are more likely to follow well-established trails in their quest for capital. They have access to an organized investment market and for the most part utilize the services of the specialists functioning in this market. Moreover,

their size and scope of operations make them nationally known; and this adds to their investment appeal. Under these conditions, it is much easier to overcome the natural resistance of investors; and big corporations are able to raise large pools of capital. Also, the securities of most large corporations are listed on national security exchanges, thereby giving them ready marketability; in contrast, sales of existing securities of small companies are effected by direct negotiation or are made over the counter.

CLASSIFICATION OF CAPITAL SOURCES

With this background, more specific attention may be given to the component elements of the market to which business enterprise must turn for its capital supply. The discussion will be confined to an analysis of the external sources, reserving for later treatment the opportunities and problems that are found in obtaining capital through the retention of income. In brief, there are three main classes or types of external sources: private institutional investors, individual investors, and the government. These may be identified as follows:

1. Private institutional investors—commercial banks, savings banks, life insurance companies, investment trusts, investment banks, pension funds, and miscellaneous.
2. Individual investors—those operating on their own account and those operating as trustees in behalf of others.
3. Public institutional investors—various governmental agencies engaged directly or indirectly in the financing of private enterprise.

The potentialities of each of these as a source of long-term capital supply may be discussed in some detail.

COMMERCIAL BANKS

While there is little express statutory limitation upon long-term lending, strictly commercial banks are presumed to engage in short-term credit. Since they obtain their funds on a demand-deposit basis, it is only logical that their investments be made so as to conform to the pattern of their liabilities. Actually, there are few banks operating under the label of "commercial" which confine their operations to demand deposits, on the one side, or to short-term loans, on the other side. Practically all have entered the savings field, and today they constitute one of the most important agencies in this area. As of June 15, 1960, the time deposits of individuals, partnerships, and corporations held by insured commercial banks amounted to $92,051,782,000 as compared with demand deposits of $109,987,978,000.

Statistics are lacking to measure accurately the part played by insured commercial banks as a source of long-term funds. However, it may be

noted that their holdings of bonds, notes, and debentures other than the obligations of federal, state, and local governments as of June 15, 1960, amounted to $7,062,675,000. It is also known that many banks have made demand loans which have for all practical purposes served as a means of providing relatively permanent capital because of a tacit agreement not to exercise the demand privilege.[1] Two more recent developments in commercial banking practice are term or intermediate loans and the provision of reasonably long-term capital to small industries through the co-operative efforts of several banks.[2]

Although commercial banks are presumed to deal mainly in short-term credit both by tradition and because of the nature of their funds, it may be observed that they should be unusually well-qualified to appraise capital needs. Not only do such banks constitute the major agency specializing in finance in many communities; but, through their servicing of the current needs of industry, they should be especially familiar with the complete need for capital. Obviously, if the function of furnishing industry with long-term as well as short-term capital were assumed on a large scale, it would suggest rather complete separation of banking officials from industry control. This would be essential if proper recognition is to be given to the desired "arm's-length" position of a financial institution. Once more, however, it needs to be reiterated that the assumption of this broader financial service by the commercial banking institutions means the abdication of numerous traditions and attitudes which have accompanied strictly commercial banking practice. The investment account would have to be separated from the commercial account and the depositing clientele fully informed of their rights and obligations.

Many will disagree as to the wisdom of converting commercial banks into institutions that render complete financial service. To a great degree, this is a matter of the ability of communities to carry or support more specialized agencies. The larger, urban centers can be expected to have a volume sufficient to support specialized facilities; but this is out of the question in rural areas and the smaller cities. In the latter, there seems to be little choice as to the course of action if attention is to be given to the more permanent needs for capital of industries in such localities. This is especially true of smaller businesses, which operate in many respects on a catch-as-catch-can basis.

Attention must also be called to the difference between the need for borrowed funds and the need for equity capital. Commercial banks clearly lack the qualities that are necessary to provide the latter. They

---

[1] See Harold G. Moulton, *The Formation of Capital* (Washington, D.C.: Brookings Institution, 1935), pp. 93–99, for discussion of permanent financing through bank operations.

[2] As of June 15, 1960, aggregate "commercial and industrial loans (including open-market paper)" amounted to $41,783,952,000.

raise funds on a promise-to-pay basis, either on a variable or fixed schedule; this creates an element of fixity unsuited to the risks adhering to the residual equity position. Here, undoubtedly, individuals will continue to furnish the bulk of the capital, as they have in the past. Perhaps the machinery for the distribution of securities of this type may be improved, particularly for purposes of facilitating the intercommunity flow and for the accommodation of small business. However, many irregularities should continue to appear as a result of the cyclical character of business activity as well as spasmodic developments of the new industry type.

SAVINGS BANKS

Giving full emphasis to the meaning of the term "savings bank," one would expect to find an institution that is ideally organized for the purpose of providing investment credit. However, traditional savings bank practice to date has restricted lending operations to a more limited area. Funds from the investing public have been accepted on a deposit basis, and their investment is of necessity made in a manner that would permit reasonable ability to pay on demand. Of the total assets of $32,210,806,000 held by federally insured savings banks as of June 15, 1960, more than one-fourth were invested in obligations of the federal government and $3,573,802,000 in the bonds, notes, and debentures of private business. Loans and discounts amounting to $21,932,283,000 included some provision of capital for industrial and commercial buildings, but by far the largest portion was represented by residential mortgage financing. It is clear that mutual savings banks serve only in a limited way as a source of capital for industry.

As the keepers or trustees of the savings of the public, savings banks quite naturally confine their investments to known and proven outlets. In pursuit of this goal, it is logical to invest indirectly in seasoned issues which have demonstrated reliability in preference to direct investment in new issues which lack a record of performance over a period of years. Possibly the responsible boards of control are faced with a paradox: if they give emphasis to the investment function and make direct commitments in new issues, they may be accused of taking unwarranted risk with the funds placed in their care; if they pursue the traditional and more conservative course, they may be charged with failure to provide industry with the necessary capital. Legal restrictions also prevent these banks from making investments in untried ventures or nonstandard securities.

LIFE INSURANCE COMPANIES

Life insurance companies are one of the major sources of investment funds of the present day. This is readily apparent in Table 30, which

shows the investments of such companies as of the close of 1959. To appreciate the extent to which capital is furnished, we may note that the insurance company holdings of industrial and public-utility bonds represent more than 50 per cent of the long-term debt of these two prominent industries.[3] Also, in recent years, life insurance companies have made large, direct investments in all types of industries, as distinguished from purchases of existing securities in the open market.[4]

In many respects, life insurance companies are the most singularly fitted of all financial institutions to provide for the long-time capital needs of industry. While provisions are included that permit the policyholders to realize a cash surrender value in the event of premature cancellation, it is the normal expectancy that the bulk of the funds is placed with life insurance companies for extended periods of time. On this assurance, these institutions are in an ideal position to extend credit that synchronizes with their own liabilities. An analysis of their investment portfolio shows that they have gone a long way in meeting this objective.

TABLE 30

INVESTMENTS OF LIFE INSURANCE COMPANIES*

December 31, 1959

Type of Investment	*Amount*
Railroad bonds	$ 3,774,000,000
Public-utility bonds	16,455,000,000
Industrial and miscellaneous bonds	25,105,000,000
Stocks†	4,561,000,000
Farm mortgages	2,844,000,000
Other mortgages	36,353,000,000
Real estate	2,687,000,000
Total government securities	11,352,000,000

* Institute of Life Insurance, *Fact Book* (New York, 1960).

† Of the stocks owned, 35.3 per cent were preferred and 64.7 per cent common. Distributed by fields of enterprise, 2 per cent were railroads, 37 per cent public utilities, and 61 per cent industrial and miscellaneous.

As indicated in Table 30, investment in stocks by life insurance companies is only minor. Inflationary tendencies which have persisted since the close of World War II have stimulated the thought that the powers of insurance companies to invest in stock be increased;[5] as a result, such investment is now authorized on a limited scale. For example, in the state of New York which is prominent as a center of life insurance companies, legislation was enacted in 1951 permitting such companies to invest in common stock up to 3 per cent of admitted assets or one-third of the

[3] Estimated by relating holdings of life insurance companies, as shown in Table 30, to long-term debt of these industries, as shown in Table 16, p. 219.

[4] See pp. 337–40.

[5] See, for example, address by Secretary of Commerce Charles Sawyer on the occasion of the one-hundredth anniversary of the Massachusetts Mutual Life Insurance Company, as reported by the *Wall Street Journal,* May 22, 1951, p. 1.

surplus account, whichever is smaller. In 1957, amendments to the law increased the authorization to the lesser of 5 per cent of admitted assets or one-half of the surplus account. There is also some evidence that life insurance companies may be seeking to develop plans to permit variable payments of the insurance coverage in order to participate on a still larger scale in stock investments, but this feature is beyond the scope of this volume.

Because of Congressional interest in the financing of small business companies, the participation of life insurance companies in this field has been the subject of public inquiry on a number of occasions. Naturally the fiduciary nature of life insurance deters investment in the stock of newly organized or small companies, but loans are made within the limits of financial prudence and statutory authorization. For example, it is reported that 67 of the larger insurance companies (accounting for 77 per cent of the assets of all life insurance companies) made 1,953 loans of less than $50,000 each for an aggregate amount of $50,121,000 in 1956; loans ranging from $50,000 to $100,000 numbered 1,075 for a total amount of $73,834,000.[6] Even so, the volume of funds demanding investment by life insurance companies is so great that there is natural catering to the financial accommodation of large corporations. Indeed, loans made by life insurance companies may occasionally exceed $100,000,000 each. Also, the enabling statutes of investment affect the investment in loans to small enterprise; for example, in the state of New York, there is prohibition of unsecured loans to unincorporated business firms.

Further analysis of the investment portfolio of life insurance companies shows decidedly the influence of the extended depression and other major developments since 1929. In that year, they held United States government bonds of approximately $370,000,000, which comprised 2.1 per cent of their total assets; in 1945, the respective figures were $20,583,000,000 and 45.9 per cent; and in 1959, the comparable figures were $6,868,000,000 and 6.0 per cent. These same insurance companies held $294,000,000 of industrial and miscellaneous bonds in 1929 and $25,105,000,000 in 1959, comprising, respectively, 1.7 per cent and 22.1 per cent of their total assets. The obvious shifts in investment position reflect clearly the changing pattern of social and economic conditions; the dominant position of government bond holdings in 1945 is largely a response to the pressures of both depression and the ensuing World War II, while the decline of such holdings and the accompanying marked increase in industrial and miscellaneous bonds indicate the effects of the long period of prosperity following the war. Also evident is the part played by life insurance companies in financing the impressive expansion of industry in recent years.

[6] See Gordon W. McKinley, "Life Insurance Lending to Small Business," *The Journal of Finance*, Vol. XVI, No. 2 (May, 1961), p. 294.

INVESTMENT TRUSTS

There are many varieties of investment trust organizations; but, in general, all have the common purpose of pooling the funds of individual investors and diversifying the resulting investment. Usually, stocks are the selected medium for investment instead of bonds, the reasons for which are not pertinent to this discussion. Because of this plan of operation, one might surmise that such institutions would constitute an ideal source of venture capital. Unfortunately, there are certain features of their operation which militate against the realization of the goal. Because stocks are selected to obtain capital appreciation as well as the normal, recurring income return, any capital obtained from investment trusts may be of a shifting variety. It is true that the diversity of opinion among such groups may well cause some other organization to replace the one that is selling out; but, at the same time, the practice gives rise to a form of capital turnover which lends an element of instability.

Illustrative of these thoughts are the actions of various investment companies during the first half of 1959.[7] Adams Express sold all of its holdings (6,500 shares) of Aluminum Limited during the first quarter, while the Madison Fund purchased 20,000 shares of the same stock in the same quarter. The latter organization also acquired 10,200 shares of Spencer Kellogg & Sons in the first quarter and then completely liquidated this holding before the end of the next quarter. Similarly, the Lehman Corporation purchased 8,000 shares of Bethlehem Steel during the first three months of the year and then disposed of the shares in the ensuing quarter. Such transactions can only mean that investment companies are motivated, and naturally so, by their appraisal of the opportunities to make capital gains or to improve the caliber of their portfolio. Despite the potential of rapid turnover of their holdings, investment companies have become an important medium for the carrying of equity capital, without which the commitment of new capital could be deterred.

Recognition of the importance of investment trusts is clearly indicated by the regulation of their operations under the Investment Company Act of 1940, which affects "companies engaged primarily in the business of investing, reinvesting, owning, holding or trading in securities." Such control is further supplemented by the Investment Adviser's Act of 1940, which requires "persons engaged for compensation in the business of advising others with respect to securities" to register with the Securities and Exchange Commission. As of June 30, 1960, there were 570 registered investment companies, with assets of approximately $23,500,000,000. For the most part, their activities are confined to listed securities; and, as indicated above, their contribution to the capital supply is mainly one of carrying existing issues rather than adding new funds which are available for corporate use.

[7] See "Large-scale Investment Decisions," *The Exchange*, November, 1959, pp. 9–11.

INVESTMENT BANKERS

Investment bankers provide the most formally organized machinery for the raising of capital funds. It is, indeed, their primary function; whereas, as has been noted, it is mainly an incidental operation in the case of the other financial agencies described. In a sense, they are not a source of capital but serve mainly as middlemen between investment outlets and industry. In addition, they often serve as advisors or consultants in the development of various types of transactions—such as mergers and the placement of private loans. Because of their importance and the leading role they have played in security distribution, a separate chapter is devoted primarily to an analysis of their operations.

PENSION FUNDS

Coming rapidly to the fore as a source of capital are corporate pension or retirement funds. In earlier years, provisions for retirement were frequently based upon unwritten understanding whereby a company agreed to pay a pension after the retirement of its officers or employees. Today, there are formal contractual arrangements under which annuity insurance is purchased or the funds are placed with trustees—often the trust departments of banks. It is reported that the book value of corporate pension funds amounted to $28,711,000,000 at the end of 1960, and that the market value was $32,177,000,000. Besides the corporate funds, insured pension reserves amounted to an estimated $19,000,000,000 and other noninsured funds to $2,300,000,000 (both figures being expressive of the book value). From these figures, it will be noted that the aggregate book amount of private pension funds was some $50,000,000,000; similar funds under governmental programs were $55,900,000,000.[8]

Our further comments may be limited to corporate pension funds because of both their greater freedom of investment and their impact on corporate financing by ownership of stock. These features may be seen in Table 31 which shows the book and market values of the security holdings of such funds as of the close of 1955 and 1960.

Indicative of the importance of corporate pension funds as a source of capital is their purchase of $1,400,000,000 corporate bonds in 1960, or almost 23 per cent of the net supply of new bond issues.[9] In the same year, common stock was purchased in the amount of $2,289,000,000, as compared with sales of $572,000,000; thus, it will be seen that the net purchases for the year amounted to $1,717,000,000. The net purchases of common stock increased each year without exception from 1951 to 1960, but, even so, the aggregate holdings as of 1959 were estimated to account

[8] Securities and Exchange Commission, Release No. 1750, *Corporate Pension Funds, 1960* (May 3, 1961), Tables 1, 3 and 4.

[9] *Ibid.*, p. 2.

for only about 3 per cent of the total common stock of all American corporations.[10]

While our consideration of pension funds is related mainly to their importance as a source of capital, there are obviously many other broad questions of significance. For example, will such funds become primary

TABLE 31

BOOK AND MARKET VALUES OF SECURITY HOLDINGS OF CORPORATE PENSION FUNDS, 1955 AND 1960*

(In Millions of Dollars)

Type of Security	Book Value		Market Value	
	1955	1960	1955	1960
U.S. Government Securities	$2,536	$ 2,035	$2,492	$ 2,013
Corporate bonds.............	7,225	14,140	7,085	13,167
Common stock:				
Own company........	434	874	933	2,013
Other companies........	2,524	8,640	3,862	12,014
Preferred stock..................	510	652	523	597

* Securities and Exchange Commission, Release No. 1750, *Corporate Pension Funds, 1960* (May 3, 1961), Tables 1 and 3, and earlier releases.

media of control of corporations? Again, what part will labor unions play in the administration of the funds? Needless to say, the unfolding of the answers to these questions may exercise profound influence upon management and corporate policy generally in the years to come.

MISCELLANEOUS INSTITUTIONS

Such other institutions as fire insurance companies, universities, and eleemosynary groups also make a sizable contribution to the capital supply. *Best's Fire and Casualty Aggregates and Averages* (*1960*) shows that fire, marine, casualty, and surety insurance companies had corporate investments of $14,614,564,000 in bonds and $9,220,922,000 in stocks as of December 31, 1959. Special reference may be made to the so-called "industrial" banks, which have commonly operated in the past under the name of "Morris Plan" banks. Despite their designation as "industrial" banks, their funds were used largely to make the familiar consumer or personal loans. Today, there is some evidence that they are becoming interested in the longer-term financing of industries—particularly small businesses. It is barely possible that they hold the potential of developing into a specialized medium for the accommodation of this form of capital supply; but, at this time, it would appear that the major developments along this line will arise out of the Small Business Investment Act of 1958

[10] Securities and Exchange Commission, Release No. 1680, *Corporate Pension Funds, 1959* (May 31, 1960), p. 2.

(see pages 331–32). Except for companies organized under the provisions of this act, it is likely that the motivation of most of the types of capital-supply institutions is one of investment for self-accommodation more than of supplying capital in a primary or functional sense.

INDIVIDUALS INVESTING FOR THEIR OWN ACCOUNT

As indicated previously, the primary and original source of all capital is found in the savings of individuals. Institutional investments are basically of the "middleman" variety, even though the prominence of their identity does give them standing in their own right. In contrast, the scattered investments of countless individuals do not lend themselves to simple, unit measurement; but, at the same time, there can be no question of either their volume or importance. Individual investors, in the aggregate, make the market; and the flow of capital is largely dependent upon their response.

The supply of capital by individuals is a result of both the investment and the speculative motive. Industry naturally prefers to attract funds that represent long-term commitments because of their greater stability; at the same time, it should be noted that the fluctuating movements of speculation do not directly affect the corporation. Once securities are issued, future trading is between outsiders and does not change in any way the amount of funds available for business use. However, in the long run, the credit position of a company is affected by speculative operations, which may have marked influence upon additional financing.

Speculators are, of course, noted for the shifting character of their activities—in and out of the market—as decision and opportunities dictate the course of their action. Those who are inclined to reach for the utopian goal of stabilized business may criticize this group as a retarding element. On the other hand, their contribution to the opening of new fields of endeavor and the expansion of existing business must be recognized as a means of adding to the public welfare. It is difficult to measure the extent of their participation, not only because of the absence of supporting statistics but also because their significance is largely qualitative rather than quantitative. Possibly, speculation may be placed in the category of a necessary evil; but it would seem to be an integral part of a private market and, judging from our wartime experience, may not be wholly eliminated even under rigid government controls and regulation.

INDIVIDUALS ACTING FOR OTHERS

Another source of capital which is worthy of mention is individuals who act for others in the capacity of trustees. The relationship is usually created either by court order or voluntarily for the purpose of administer-

ing various types of estates. While attention is presently being directed to individuals as a source of funds, reference may also be made to fiduciary institutions which serve in a similar manner and, indeed, undoubtedly account for a much larger volume of business of this nature. Investments under the administration of national bank trust departments alone amounted to $39,798,689,090 as of December 31, 1959; of this amount, stocks accounted for $10,488,023,813, and bonds, $24,959,845,727.[11] Irrespective of the type of trustee, the primary objective usually is to seek a safe investment of the principal while providing an assured income return. As a result, funds obtained from estates are likely to be of a long-term character; and there is considerable freedom from the well-known speculative pressures. Complete and accurate statistics are lacking to measure the importance of estates as a source of capital, but it may be safely said that they represent a well-recognized segment of the money market.

GOVERNMENT AND THE PROVISION OF CAPITAL

Prior to the onslaught of the prolonged depression of the thirties, there was little occasion to give serious consideration to the government or its agencies as a source of capital. It was presumed that funds could readily be attracted in response to the opportunities of industry. Emphasis was therefore placed upon the risk innate in a given industry, and the rate of return was determined accordingly. When the risk was high, prospects of compensating income were essential to attract capital; oppositely, established industry with less risk was able to raise funds at lower rates of dividends or interest. In this earlier period of national expansion and optimistic outlook, the major emphasis was placed upon industry risk, as distinguished from business risk. The basic or secular trend of business was presumed to be favorable, and the chief determinant of capital diversion appeared in the segregation of the risks of individual industries.

Today, the automatic correction of economic adversity by voluntary action is no longer taken for granted, and there is fairly wide acceptance of the belief that the government should manage the economy by means of credit policies and other more limited direct measures. The underlying doctrine was given great impetus as a means of promoting business recovery in the thirties; even more sweeping control became a necessity to meet the demands of World War II; and, since that time, it has been developed as deliberate public policy aimed at the preservation of business prosperity. Government participation in the field of private business is no longer shocking to the public, and the major question is one of determining the extent of its use. Probably both political expediency and the pressure of various national and international problems will provide the answer.

[11] *97th Annual Report of the Comptroller of the Currency for the Year 1959* (Washington, D.C.: U.S. Government Printing Office, 1960), p. 124.

The limitation of space and the purposes of this volume deter the discussion of the large role that government is now playing in our economy, but we should take note of its direct and indirect programs to stimulate the availability of capital for private use.

THE RECONSTRUCTION FINANCE CORPORATION

Although the operations of the Reconstruction Finance Corporation were terminated on June 30, 1954, it is still of interest to the student of finance as a landmark of direct financing of business by the federal government. Created in 1932, it quickly became known as the RFC, and promptly put into action its duties "to provide emergency financing facilities for financial institutions, to aid in financing agriculture, commerce and industry, and for other purposes." To meet these objectives, the corporation authorized total loans of $10,306,038,741 during the first seven years of its operation; and, in addition, the Congress made direct allocations of $2,900,601,066. Considering the former only, cancellations of $2,293,568,866 were reported; and the net disbursements were $7,243,873,197. Of this amount, approximately $2,100,000,000 represented commitments to banks to meet the withdrawal demands of depositors and to strengthen their underlying base of capital stock. The economic ills of the early thirties were largely in the nature of a financial crisis, and the RFC moved vigorously to revive this flagging nerve center of business activity. Railroads, including their receivers and trustees, obtained loans of approximately $827,000,000; and advances of about $161,000,000 were made to business enterprises. Most of the latter were for the accommodation of small business—37 per cent being loans of $5,000 or less; 53 per cent, $10,000 or less; and 83 per cent, $50,000 or less.[12] In brief, the RFC paid particular attention to the areas of greatest distress; and its policy was one of turning the tide of business adversity so as to enable private business to pick up the momentum of recovery.

As suggested by the corporate name, it is likely that the RFC was intended as a temporary agency which would be liquidated upon the fulfillment of the purposes previously stated. But governmental agencies do not die easily, and our times seem to create new emergencies. Giving voice to the latter thought, one government official has said that the government has "moved from an emergency to a crisis and then back to another emergency to start over again." In any event, World War II created a pressing and enlarged need for the services of the RFC; and its business increased in volume. From its creation in 1932 to December 31, 1945, just after the close of the war, the RFC and its subsidiaries "disbursed $34,-584,000,000 in loans, purchase of securities, construction of defense

[12] Reconstruction Finance Corporation, *Seven Year Report (February 2, 1932 to February 2, 1939)*, p. 9.

plants, purchase of strategic materials, production of synthetic rubber, payment of subsidies, and for other purposes."[13]

In the war program, most of the rules of the market were forgotten. The only goal was to expedite the production and distribution of goods and services for military use. As a result, the activities of the RFC during this period have little applicability to normal financial operation except to emphasize the fact that the functioning of private enterprise is largely dependent upon the existence of economic equilibrium. Even so, we can well afford to observe the record in order to appreciate the application of financial principles under these conditions as well as to be informed of this exciting period of business history. In large measure, the source of capital for war production disappeared as a problem for private industry, the great bulk of the funds being provided by the government through the RFC or its subsidiaries. The promotion of new projects was no more difficult than the expansion programs of existing companies because there was little need to show the financial soundness of either. In aircraft alone, 574 plants represented an investment of $3,100,000,000; and 57 plants, with a cost of $715,000,000, were built to produce synthetic rubber. Altogether, the Defense Plants Corporation, a subsidiary of the RFC, made total commitments for 2,098 plants, aggregating $7,939,465,-000, from 1940 to the end of 1944.[14] Other subsidiaries were the Rubber Reserve Company, the Metal Reserves Company, the Defense Supplies Corporation, and the War Damage Corporation, their titles being suggestive of the nature of their activities. Following the war, most of these war projects were liquidated, and the surplus property was turned over to the War Assets Administration for disposal.

Following the close of the war, the RFC became the subject of considerable controversy, and strong demands were made for its early liquidation. These pressures came to a head with the stopping of its authority to make new loan commitments as of September 28, 1953, and, as indicated previously, its liquidation as of June 30, 1954. The latter was accomplished by the transfer of the assets to other governmental agencies on the basis of fitting them into appropriate continuing programs; however, some $392,239,565 of the assets were transferred to the United States Treasury Department for liquidation. As of the closing date, total assets after allowance for losses of $39,515,061, amounted to $590,041,-604, and cumulative retained earnings were $251,000,000.[15]

---

[13] *Summary Statement Covering the Budget Estimates of the Reconstruction Finance Corporation and Its Subsidiaries for the Fiscal Year 1947.*

[14] Under date of January 15, 1945, the Reconstruction Finance Corporation succeeded to all the powers, duties, etc., of the Defense Plants Corporation.

[15] See *The Budget of the United States Government for the Fiscal Year Ending June 30, 1956* (Washington, D.C.: U.S. Government Printing Office, 1955), pp. 193–203.

PRIVATE ADAPTATION OF THE RFC PLAN

The question may now be raised as to whether or not the basic plan of the RFC would function under strictly private direction. The private financial structure has long provided an adequate mechanism for the short-term needs of business. Various types of financial agencies, particularly commercial banks, extend credit to both small and large business enterprises. Here, the lending institution operates in the role of principal and not as agent of those who provided the funds. For the most part, there are no similar accommodations for long-term lending. Instead, the agency principle has been employed whereby the intermediary organization simply attempts to bring the investor and the borrower together. In view of the circumstances, borrowers are compelled to resort to diverse and scattered sources. Under the system used by the Reconstruction Finance Corporation, prospective borrowers have a focal point which is readily accessible. The question is most pertinent as to whether or not a similar system could be worked out under private auspices.

Another advantage of long-term lending institutions acting in the capacity of principal is to be found in the resulting diversification of risk. Not only does this provide a form of carrying power for the lending institution itself, but in addition it serves to dilute the risks of investors. This is, of course, the chief advantage of the investment trust, to which reference has been made previously. However, in this particular instance, it operates in connection with the direct extension of loans to industry; whereas it will be recalled that investment trusts for the most part confine their operations to seasoned securities which have ready marketability.

A third favorable quality of a long-term lending institution, be it public or private, may be found in the possibilities of a lower cost of money to the borrower. Bulk distribution of the securities of the investment bank would obviously facilitate sale more than the smaller-scale and dividend marketing of the securities of the individual companies. Not only would this be warranted on a cost basis; but, in addition, the reduction in the aggregate risk made possible by a specialized investment institution would likely have more market appeal than the more concentrated risk to be found in buying the securities of the individual borrowers.

It should be remembered that any proposed private investment institution of this type, as well as the Reconstruction Finance Corporation, would for the most part be compelled to furnish capital on a loan basis. It is questionable as to whether such a device could be used to raise equity capital. To attempt the latter would involve perplexing questions of management and control as well as the propriety of the risk assumption which would follow. In some respects, holding companies have operated in a manner that gives this result; but the experience to date has not

been too satisfactory. It is granted that private adaptation of the RFC plan may not be feasible and that the real solution may be found in the further cultivation of the individual investor. Possibly a plan of tax incentive designed to encourage equity investment may help; and one writer, in studying the question of again making the individual investor the dominant source of equity capital, said, "First and foremost would be to bring to everyone the realization of the function of private investment."[16]

SMALL BUSINESS INVESTMENT COMPANIES

Somewhat illustrative of the foregoing thoughts are the small business investment companies which are recognized and supported by the Small Business Investment Act of 1958.[17] As the terminology suggests, the purpose is to obtain funds for small business enterprise. The granting of licenses to small business investment companies and the administration of the broad program comprise part of the functions of a federal agency, the Small Business Administration, whose other activities will be noted later.

As of June 30, 1960, the Small Business Administration (commonly known as the SBA) had in force 108 licenses to small business investment companies with capital of $70,402,364, of which $59,202,364, or 84.1 per cent, was raised from private sources.[18] The remaining $11,200,000 represented commitments from the SBA in the form of subordinated debentures; under Section 302 of the act, such investments may be made to facilitate the initial formation of these specialized investment companies. Pursuant to Section 303 of the act, the SBA is further authorized to make loans to such companies up to 50 per cent of their capital and surplus to provide additional working capital. As may be seen from the earlier figures reporting the combined capital, aggregate additional funds authorized on this basis amounted to about $35,000,000 as of June 30, 1960. Actually only 11 licensed companies had applied for such loans in the amount of $2,390,828, and $800,000 had been disbursed as of the indicated date.

It is intended that the great bulk of the funds to be raised by small business investment companies will come from private sources, including public offerings of their own securities. An example of the latter is the offering in February, 1961, of 1,300,000 shares of common stock (par value, $1.00) of the Midland Capital Corporation at a price of $12.50 per

[16] Lewis A. Froman, "Can Individual Investors Be Induced to Furnish More Equity Capital?" *The Journal of Finance*, June, 1950, p. 192. See *ibid.*, pp. 170–214, for discussion of the general subject of "Stimulating Investment in Equity Securities." Also see Stahrl Edmunds, "Financing Capital Formation," *Harvard Business Review*, Vol. XXVIII, No. 1 (January, 1950), pp. 33–41.

[17] P.L. 85–699.

[18] Small Business Administration, *Fourteenth Semiannual Report for Six Months Ending June 30, 1960*, p. 54.

share. The sale of the shares had the usual sponsorship and support of investment bankers to be discussed in the next chapter.

The funds raised by small investment banking companies are in turn invested in operating companies in accordance with arrangements worked out by the interested parties. Thus far, the most common form of financing has been convertible bonds, commonly bearing at the present time an interest rate of 8 per cent and a maturity of five years. These terms may appear harsh by comparison with the financing of large-scale enterprise, but are likely more favorable than the costs of direct financing by small business in the open market. One of the major reasons for issuing convertible bonds is the prospect that successful operation would make conversion attractive, and thereby enlarge the all-important net worth as a basis for future financing.

Since no one investment company of this type may invest more than 20 per cent of its capital in a single operating company, there is a tendency to resort to syndicate or pooling arrangements as a means of enlarging the investment potential. Usually such co-operation is on a sectional or regional basis; and it is further intended that such groups will serve as intermediaries to disseminate information as well as to render other miscellaneous services.

SMALL BUSINESS ADMINISTRATION—OTHER FUNCTIONS

The SBA is "the first independent Government agency created to serve and represent all small business both in peacetime and in periods of national emergency."[19] It is intended to help small business: (1) "gain access to adequate capital and credit," (2) "obtain a fair share of Government procurement," and (3) "obtain competent management, technical and production counseling."[20] The lending authority of the SBA commenced on the same date that the authority of the RFC expired.

Summary Statement of Business-Loan Activities. To June 30, 1960, the SBA approved 20,362 business loans for $955,191,000, or an average of almost $47,000 per loan. Direct loans may not be made if funds are otherwise available on reasonable terms, and must be on a "participation basis" unless this is not feasible. By participation, it is meant that SBA joins with a bank or other financial medium in making the loan.

There are two forms of participating arrangements—deferred and immediate. Under the deferred plan, the private lending medium advances the entire amount of the loan proceeds, and, upon demand, the SBA pays up to 90 per cent of the unpaid balance. The lender pays the SBA a fee which ranges from ½ of 1 to 1 per cent per annum, the exact percentage

---

[19] Small Business Administration, *Fourth Semiannual Report for Six Months Ending June 30, 1955*, p. 1.

[20] *Ibid.*

being related to the degree of participation. Where there is immediate participation, there are two alternative procedures: (1) the SBA may disburse the entire amount and participate in the loan up to 90 per cent with the balance being assumed by the private participant, or (2) the private lender may advance the entire amount and retain at least a ten per cent position, with the balance being taken over by the SBA. Through June 30, 1960, private lenders participated in 13,031 of the aggregate number of loans made.

Another variation of participating arrangements is the so-called "limited loan participation plan." In this case, the SBA joins with the private lender up to a maximum of $15,000, or 75 per cent of the loan, whichever is lesser. It is reported that this "program is designed to assist . . ." many ". . . small businesses which have a minimum of tangible assets to pledge for a loan."[21] Through June 30, 1960, some 5,396 loans of this type were approved in the amount of $79,915,000; of the latter, retail trade businesses and manufacturing companies accounted for $36,317,000 and $16,786,000, respectively.

With respect to the nature of small business loans generally, it is reported that over 90 per cent of the loans to manufacturers were to firms each with fewer than 100 employees, and that 30 per cent of the loans were made to companies with less than ten employees each. At the outset loan proceeds were used particularly to augment working capital but, more recently, there is greater use of the funds to consolidate existing obligations.

Disaster Loan Program. Brief mention may be made of the program to assist small business in disaster areas. For the cumulative period ended June 30, 1960, the SBA had approved 9,241 disaster loans for $97,031,000, of which the agency's share was $93,371,000. Of the total approved loans of this type, 198 loans for $4,269,000 were responsive to the needs of drought areas, and 641 loans for $11,584,000 were for the purpose of meeting needs caused by excessive rainfall.

Development Company Loan Program. Under Title V of the Small Business Investment Act of 1958, authorization is given to the SBA to make loans to state and local development companies. Such enterprises, as the terminology suggests, operate for the express purpose of encouraging and assisting the development of private enterprise, and the scope of the operations naturally depends upon their state or local sponsorship. State development companies are required to obtain capital from sources other than the SBA before they can procure additional financing from the latter; local companies of this type, of which there were more than 3,000 as of June 30, 1960, must also provide a reasonable portion of the funds required to finance a project.

---

[21] *Fourteenth Semiannual Report, op. cit., p.* 31.

FINANCING BY FEDERAL RESERVE BANKS

To complete the picture of governmental activity in the furnishing of capital to private institutions, brief reference should be made to loans made by the well-known Federal Reserve Banks. In 1934, the Federal Reserve Act was amended so as to permit the Federal Reserve banks to aid in furnishing working capital. Section 13 (b) (a) provides in part: "In exceptional circumstances when it appears . . . that an established industrial or commercial business . . . is unable to obtain requisite financial assistance on a reasonable basis from the usual sources, the Federal Reserve Bank . . . may make loans to . . . such business . . . for the purpose of providing it with working capital, but no obligation shall be . . . made hereunder with a maturity exceeding five years." Section 13 (b) (b) gives the Federal Reserve banks authority to discount or purchase similar obligations which may arise from loans of the type made by financial institutions.

Limited assistance was provided by the Federal Reserve banks, but the authority for such financing was repealed by the Small Business Investment Act of 1958. However, the question may be raised as to whether the Federal Reserve System can properly serve as a direct lender of funds to specific institutions and still maintain a position of objectivity in carrying out its primary function—serving and stabilizing the entire economy.

SUMMARY OF SOURCES OF CAPITAL

Irrespective of the source of capital, it must be clear that the response of investors to the needs of business enterprise must be conditioned upon the vagaries of opportunity. Promising business conditions have usually been found sufficient to attract private funds in sufficient volume, but the abnormal conditions of recent years have confused the business outlook. Under the circumstances, government has tried to bolster private facilities and has resorted to more direct excursions of assistance in order to stimulate business. The most recent example of such governmental action is the Small Business Administration. But the activity of government, also, must be conditioned over the long run upon the soundness of the purpose for which funds are desired as well as the worthiness of the applicant. How far the government will carry its sponsorship and support of lending to private enterprise remains an open question. The answer will likely be found in the more or less normal evolutionary change of society and, possibly, in the more abnormal uncertainties which overhang the future.

QUESTIONS AND PROBLEMS

1. Discuss the influence of the following upon general economic conditions: (*a*) availability of new capital; (*b*) cost of new capital; (*c*) other financial terms and conditions.

2. Show how the position as a debtor or creditor nation may affect the supply of capital for private business operations.
3. While many corporations obtain the great bulk of their funds from retained earnings, the supply of fresh capital by personal savings has impressive marginal significance. Discuss.
4. Discuss the reasons why institutional investors have increased in importance as a source of funds.
5. Do you think that institutional ownership tends to have a stabilizing influence on the capital market?
6. To what extent should government adopt measures designed to influence interest rates and promote the availability of funds?
7. Discuss the differences in the problems of raising capital by the sale of stock as compared with bonds.
8. "It is highly improper to use deposits (either demand or savings) as a source of funds to accommodate long-term capital needs." Comment. Consider, also, the investment in long-term existing securities in the same light.
9. Discuss the general question of investment by life insurance companies in the following: common or preferred stock of new companies, common or preferred stock of existing companies, and bonds of either new or existing companies.
10. Consider (*a*) the economic problems which may arise as a result of a large concentrated holding of securities by a life insurance company; (*b*) the advantages.
11. Evaluate the problems of stock ownership by pension funds, and particularly the following: (*a*) the propriety of investing such funds in common stock; (*b*) the possible ultimate effects upon the nature of our economy.
12. Discuss the importance of investment trusts as a source of capital and evaluate their possible influence upon the control and management of corporations.
13. Discuss the advantages and disadvantages of the government's (*a*) lending money to private institutions; (*b*) insuring or guaranteeing private investment.
14. Discuss the merits of establishing emergency corporations, such as the Reconstruction Finance Corporation, to cushion the shock of serious economic adjustment and to stimulate business recovery.
15. Do you think the existence of the Small Business Administration is justified in a period of high business activity? Do you think that small business enterprise needs such special accommodation irrespective of business conditions? Do you think it is necessary to preserve the democratic nature of private business enterprise?
16. Evaluate the role of the Federal Reserve System in the functioning of our economy. Do you think that the Federal Reserve banks should make direct loans to private institutions?

REFERENCES

Anderson, Clay J. "Trends in the Supply of Equity Capital," *Harvard Business Review,* Vol. XXVIII, No. 5 (September, 1950), pp. 79–89.

Andrews, Victor L. "Pension Funds in the Securities Markets," *Harvard Business Review,* Vol. XXXVII, No. 6 (November–December, 1959), pp. 90–102.

BECKHART, BENJAMIN H. (ed.). *Business Loans of American Commercial Banks.* New York: The Ronald Press Co., 1959.

BUTLER, WILLIAM F., and ULIN, ROBERT P. "Business Needs for Venture Capital," *Harvard Business Review,* Vol. XXVIII, No. 4 (July, 1950), pp. 52–65.

CONKLIN, GEORGE T., JR. "Corporate Bond Market," *The Journal of Finance,* Vol. XVI, No. 2 (May, 1961), pp. 265–71.

HARBRECHT, PAUL P. *Pension Funds and Economic Power.* New York: The Twentieth Century Fund, 1959.

INVESTMENT BANKERS ASSOCIATION OF AMERICA. *Equity Capital for Small Business Corporations.* Washington, D.C.: Investment Bankers Association of America, 1955.

JACOBY, NEIL H., and SAULNIER, RAYMOND J. *Business Finance and Banking.* New York: National Bureau of Economic Research, Inc., 1947.

MILLER, GLENN R. "Long-term Small Business Financing from the Underwriter's Point of View," *The Journal of Finance,* Vol. XVI, No. 2 (May, 1961), pp. 280–90.

MONAHAN, DELONG H. "The Investment Banker and Private Placements," *Commercial and Financial Chronicle,* Vol. 183, No. 5522 (April 5, 1956), pp. 1, 39–42.

SCHWEIGER, IRVING. "Adequacy of Financing for Small Business Since World War II," *The Journal of Finance,* Vol. XIII, No. 3 (September, 1958), pp. 323–47.

SOLDOFSKY, ROBERT M. "The Size and Maturity of Direct-Placement Loans," *The Journal of Finance,* Vol. XV, No. 1 (March, 1960), pp. 32–44.

TEMPORARY NATIONAL ECONOMIC COMMITTEE. *Study of Legal Reserve Life Insurance Companies.* Monograph No. 28. Washington, D.C.: U.S. Government Printing Office, 1941.

WEISSMAN, RUDOLPH L. *Small Business and Venture Capital,* chaps. iii and iv. New York: Harper & Bros., 1945.

Chapter 18 ►

THE DISTRIBUTION OF SECURITIES

COMPLEMENTARY to the sources of capital are the means by which funds are actually raised. Few difficulties develop when sufficient capital is obtained from the accumulation of earnings; but when it is sought from outside sources, there are all the problems of any marketing operation. The sale of securities has many of the basic characteristics found in the sale of goods and services; at the same time, it is a highly specialized activity requiring distinct skill and experience. When corporations sell their securities directly to one or a limited number of large institutional investors, there is minimum need to engage outside assistance because the certainty of getting the funds is promptly assured. However, if funds are to be obtained from the public, most corporations transfer the task to investment banking houses which specialize in this function.

PRIVATE PLACEMENT OF SECURITIES

As noted in Chapter 17, Table 29, the private placement of new bond issues now plays a prominent role in corporate financing. It is likely that this development is the result of two major factors: (1) the disorganized condition of securities markets in the thirties and (2) the large amount of funds held by institutional investors for investment. Particularly prominent are the life insurance companies; of their aggregate holdings of $25,105,000,000 bonds of industrial and miscellaneous companies at the close of 1959, it is estimated that about $22,000,000,000 was acquired by direct placement.[1] In an earlier period, 1946 to 1949 inclusive, one authority reported that the 18 largest insurance companies, alone, accounted for almost 90 per cent of the total of such financing.[2]

[1] See *Life Insurance Fact Book* (New York: Institute of Life Insurance, 1960), p. 77.

[2] E. Raymond Corey, *Direct Placement of Corporate Securities* (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1951), pp. 5–6.

With the rapid development of other forms of institutional investors, there has undoubtedly been some decline in the position of life insurance companies as virtually the sole originator of private placements.

Among the arguments advanced in favor of direct placement are the following: (1) the greater ease and convenience in dealing with a single or limited number of investors, (2) quick determination of the certainty of getting the funds, and (3) the facility of "tailoring" the terms of the loan to fit the needs of the borrowing corporation. Illustrative of point (3) is an arrangement whereby not all of the funds are advanced at a single time but, instead, are made available over a reasonable period of time. It is also contended that the cost of placing security issues directly is less than that of a public offering. For example, the Standard Oil Company of New Jersey had the following costs of floating a public offering of $150,000,000 and placing directly a note issue of $75,000,000 in 1949:[3]

Explanation	Debentures	Notes
Price to purchasers	100.50	101.00
Flotation costs—percentage of gross proceeds	1.01	0.12

Probably no generalization should be made from this one instance; but, at the same time, it would be reasonable to expect that the costs of making a direct placement should usually be less than the flotation costs of a public offering.

Whether or not corporations are wise, in the long run, to rely upon large institutional investors for funds remains to be seen. However, it may be observed that such a policy tends to weaken the contacts and credit standing which corporations establish with individual investors when using public offerings. In addition, they become dependent, to a degree, upon the investment attitudes and abilities of a relatively small number of institutional investors. At the same time, it should be said that some authorities believe institutional investors to be more dependable in uncertain times than the general public, which has often displayed a pattern of cyclical response.

To note the difficulties that may occur in placing full reliance upon institutional investors, attention may be called to the conditions that arose in late March, 1951. Up to that time, life insurance companies, banks, and others were generally selling government bonds and reinvesting the proceeds in private securities which paid a higher return. However, when the Board of Governors of the Federal Reserve System abandoned its policy of supporting government bonds so as to maintain a price above par, prices on taxable issues generally sank below this level. As a result, institutional investors were no longer able to continue their previous

[3] *Ibid.*, p. 62.

practice with the same facility, since the sale of governments by them would necessarily cause a loss. In turn, the volume of funds available for investment in private securities was affected. Also, it is apparent that the development and maintenance of marketing facilities for public offerings are dependent upon volume, and they necessarily suffer when direct placement is made.

It is also believed by some that the direct placement of securities has been influenced by registration and other statutory requirements relating to the issuance of new securities. Industrial companies have considerably

TABLE 32

HOLDINGS OF RAILROAD, PUBLIC-UTILITY, AND INDUSTRIAL BONDS BY U.S. LIFE INSURANCE COMPANIES (1921–59)*

(In Millions)

Year	Railroad Bonds		Public-Utility Bonds		Industrial and Miscellaneous Bonds	
	Amount	% of Assets†	Amount	% of Assets†	Amount	% of Assets†
1921	$1,775	22.4	$ 138	1.7	$ 48	0.6
1925	2,238	19.4	687	6.0	97	0.8
1929	2,853	16.3	1,432	8.2	294	1.7
1933	2,775	13.3	1,757	8.4	369	1.8
1937	2,769	10.6	2,801	10.7	983	3.7
1941	2,858	8.7	4,873	14.9	1,842	5.6
1945	2,948	6.6	5,212	11.6	1,900	4.3
1947	2,844	5.5	6,941	13.4	4,969	9.6
1949	3,017	5.1	9,764	16.4	8,680	14.6
1951	3,307	4.9	11,235	16.4	11,441	16.8
1953	3,643	4.7	12,827	16.3	15,527	19.7
1955	3,912	4.3	13,968	15.5	18,179	20.1
1956	3,877	4.0	14,520	15.1	19,787	20.6
1957	3,863	3.8	15,252	15.1	21,717	21.5
1958	3,843	3.6	15,938	14.8	23,439	21.8
1959	3,774	3.3	16,455	14.5	25,105	22.2

* Source. *Life Insurance Fact Book, 1960* (New York: Institute of Life Insurance, 1960), pp. 73–76.
† Percentage of total assets owned by life insurance companies.

more freedom in this respect than public utilities or railroads engaged in interstate commerce. In the latter two areas it is necessary to secure approvals of new issues, offer them on a competitive-bid basis, and meet various other requirements. As a result, the direct placement of securities is not used as much by railroad and public-utility companies as by industrial companies. As evidence bearing upon this condition, we may note the trend in the holdings by life insurance companies of bonds of railroads, public utilities, and industrials, as shown in Table 32.

The direct placement of securities with one or a limited number of investment outlets is generally applicable to debt obligations. Of the private placements of $3,755,000,000 reported by the Securities and Exchange Commission for the year ended December 31, 1959, only $122,-

000,000 were equity issues.[4] The two major deterrents to the handling of stocks by private placement are: (1) lack of legal authority of institutional investors to make such investments except on a limited scale, and (2) the general need to give the existing stockholders the first opportunity to subscribe for the new issue. In addition, it is likely that the control and risk incidents of stock restrain its placement on a private basis.

PUBLIC OFFERINGS

Since the direct placement of securities is a comparatively close, private transaction, our discussion will be limited primarily to public offerings. Such sales are usually effected through investment bankers, and we may quickly gain an appreciation of the scope of their activities by noting the volume of underwriting reported in Table 33. Corporations of the

TABLE 33

DOMESTIC CORPORATE UNDERWRITING OF PUBLIC OFFERINGS, 1950–60*

Year	Number of Issues	Amount
1950	563	$3,636,448,269
1951	674	3,611,800,305
1952	714	4,929,887,700
1953	704	4,797,467,891
1954	836	5,848,337,820
1955	949	6,009,934,218
1956	870	6,973,369,320
1957	738	8,813,187,691
1958	628	8,121,595,111
1959	1,012	6,257,200,354
1960	1,226	6,927,510,234

* *Investment Dealers' Digest*, February 6, 1961, sec. 2, p. 18.

utility and industrial type account for the great bulk of the financing shown in Table 33; for example, in 1960, their issues represented almost 90 per cent of the total domestic corporate flotations.

Also, for the sake of certainty of understanding, we should note that the term "public offerings" literally means that the securities are available to the general public at the time of their issuance. Not included is a considerable amount of stocks, convertible bonds, and exchanges of securities where the first offering rights may run to holders of existing securities. However, as we shall observe in the next chapter, investment bankers may underwrite flotations of this type. Specifically, from 1952 to 1960 inclusive, they underwrote more than 45 per cent of the volume of such

[4] See Table 29, p. 315.

issues in every year except two; in 1958, underwritten issues accounted for 29.0 per cent and, in 1960, for 31.0 per cent. During this nine-year period, the underwriting feature was most prominent in 1957, when it was applicable to 67.8 per cent of the total amount of offerings to existing security holders.[5]

ADVANTAGES OF USING INVESTMENT BANKERS

In considering the advantages of using investment bankers, it should be stressed that we are not now concerned with private placement; rather, our discussion will relate to offerings available for general distribution and to the benefits derived from using investment bankers as compared with the sale of the securities by the corporation itself. In the background, there are many reasons why the task of selling securities is transferred:

1. *Economy.* The corporation, chiefly concerned with the manufacture and sale of goods and services, has occasion to raise funds at relatively infrequent intervals. Investment bankers, on the other hand, are specialists in the business of floating corporation securities and are able to act upon well-established procedures and to use financial outlets of long standing. For this reason, in the long run, the corporation is able to raise funds more cheaply by the assignment of the task to a specialized agency.

2. *Certainty.* The financing of business needs normally requires planning months in advance and is dependent upon complete assurance that the funds will be forthcoming on schedule. If the corporation undertakes to sell its own securities, an extraneous risk is assumed which may serve to deter physical operations. Transfer of the security-selling function to the specialized investment banker avoids this risk and provides certainty that the funds will be available when needed.

The most common arrangement used for the sale of a new security is to have a definite and binding commitment on the part of the investment banker to provide the funds irrespective of the success in disposing of the securities. Such a plan constitutes *underwriting* in the true sense of the word. Under another plan, the sale of the securities may be arranged on a commission or "best-efforts" basis.[6] While the term "underwriter" is used loosely to mean an investment banker in both arrangements, the description is not technically accurate when there is no outright agreement to guarantee, without reservation, the delivery of the stated amount of funds represented by the security offering.

3. *Advice.* By engaging the services of an investment banker, the corporation receives the benefit of the advice of a specialist in the practical field of security distribution. Information may be given as to the timing

---

[5] See *Investment Dealers' Digest,* February 6, 1961, sec. 2, p. 202.

[6] See p. 349.

of sale and as to the type of securities that can be distributed to the greatest advantage; and various services may be rendered in clearing the numerous legal and technical problems. Technical advice is particularly essential today in order to comply with the registration requirements of the Securities Act of 1933 as well as with the regulations prescribed by the Securities and Exchange Commission. Not only may the banker act as a consultant for a particular issue, but friendly relations may exist between a corporation and the investment banker over long periods of time.[7]

4. *Prestige.* By selling securities through established banking houses, prestige may be added to many corporate issues. Some houses have a public reputation of taking part in the distribution of only the better classes of securities. If such a banking house is engaged, the corporation may receive a better price for its issue.

5. *Market Protection.* New securities lack the seasoning and stability of older issues which have been tried and tested over a period of time. Some of the purchasers of a new issue may be speculators who buy to take advantage of the usually expected rise in price; others may be individuals and institutions who have bought on the spur of the moment and later come to doubt the advisability of their purchase. Both classes may be inclined to sell shortly after the issue has been fully distributed and be the cause of an unfavorable price reaction. When securities are marketed by investment bankers, an effort is made to support the market during and after the preliminary selling.[8] Buying to support the market can do little to counteract major declining trends, but it may offset temporary irregularities. When successful, the financial position and prestige of the corporation are enhanced; and the purchasers of securities are more apt to become a stable source of funds.

FUNCTIONS OF INVESTMENT BANKERS

There is often general failure to appreciate the productiveness of the services of investment bankers, as is the case with most middleman functions. These functions are of the utility and service type and do not lend themselves to the objectivity of measurement which is possible in production activities leading to a change in the form of substance or material. In retrospect, it is now apparent that the policies and practices of investment

[7] See "New Money for Industry," *Business Week*, November 30, 1940, pp. 42–52, for an informal and revealing discussion of the relationships between investment bankers and corporate management.

[8] For example, *Prospectus*, September 23, 1947, covering the sale of common stock of the ABC Vending Corporation, provides: "The Underwriter may buy and sell shares of Common Stock in the open market or otherwise . . . for either long or short account on such terms and at such prices as it in its discretion deems desirable . . . , provided, however, that at no time shall the commitment . . . exceed 10% of the number of shares of Common Stock which the Underwriter has agreed to purchase."

bankers have at times been deficient in contributing to the public interest; but this probably is true, also, of other economic agencies. In any event, it is essential to keep in mind that the functions are a necessary part of the financial system and provide a service both to society as a whole and to the individual and institutional investor. Among the broader services to society, the following should be mentioned:

1. The productive process is facilitated by the raising of capital funds.
2. The bankers eliminate many issues which lack economic soundness through the process of investigation prior to the acceptance and handling of security issues.
3. Recognized outlets for the surplus funds of investors are furnished.

From the point of view of the investor, the following services are performed by the banker:

1. Supplying the investor with information needed for investment purposes through advertisements, prospectuses, reporting services, and occasional advisory letters.
2. Advising the investor as to what investment is most adaptable to his particular needs.
3. Performing much of the investigation required for intelligent investment, which in most instances is not only too expensive for the individual investor but also well beyond the scope of his experience.
4. Furnishing miscellaneous services, such as the safekeeping of security issues and the collection of interest and dividends.

THE NATURE OF AN INVESTMENT BANKING HOUSE

While it is easy to state that an investment banking house is a business engaged in the buying and selling of securities, it is difficult to go out in the world of practice and say, "There is an investment banker just like the description in that book." Many institutions engage in operations other than investment banking and resemble the typical department store more than the specialized retail unit. For example, it was common in earlier years to find a mixture of commercial and investment banking functions; however, in 1933, legislation was enacted to compel their separation. Another form of multiple activity is the combination of brokerage operations with investment banking. In many respects, the two types of business lend themselves to common sponsorship, since the stock in trade is identical; the chief difference is found in the relationship to the customer. The broker acts in the capacity of agent, and the investment banker serves as a principal.

The long depression of the thirties has also had a marked effect in changing investment banking practice, as well as in influencing its general reputation. In earlier years, it was possible for a prominent banking house to advertise that no clients had ever lost money through failure of the companies whose bonds it had sold. It is doubtful if a single banking con-

cern could make such a statement today. Economic devastation, combined with various legislative measures of reform, has also caused many investment bankers to fail or to undergo drastic reorganization. A contributory cause of the failure of some houses was their effort to maintain the values of securities that they had sold, either through market support or outright redemption.

TABLE 34

FIFTEEN LARGEST PUBLIC OFFERINGS OF CORPORATE SECURITIES IN 1960*

Amount of Offering	*Security Offering*	*Underwriting Managers*
$250,000,000†	American Telephone & Telegraph Co. debenture 4¾'s, due in 1992.	Morgan, Stanley & Co.
150,000,000	General Motors Acceptance Corp. debenture 4⅝'s, due in 1982.	Morgan, Stanley & Co.
125,000,000	International Bank for Reconstruction and Development debenture 5's, due in 1985.	Morgan, Stanley & Co.; First Boston Corp.
125,000,000	Republic Steel Corp. debenture 4⅜'s, due in 1985.	First Boston Corp.; Merrill Lynch, Pierce, Fenner & Smith, Inc.
100,000,000†	Southwestern Bell Telephone Co. debenture 4⅝'s, due in 1995.	Halsey, Stuart & Co., Inc.
75,000,000	C.I.T. Financial Corp. debenture 5⅛'s, due in 1980.	Dillon, Read & Co.; Kuhn, Loeb & Co.; Lehman Brothers.
75,000,000†	Consolidated Edison Co. of N.Y. first-refunding 5's, due in 1990.	First Boston Corp.; Halsey, Stuart & Co., Inc.
75,000,000†	Southern Bell Telephone & Telegraph Co. debenture 5's, due in 1997.	Morgan, Stanley & Co.
72,000,000†	Pacific Telephone & Telegraph Co. debenture 5⅛'s, due in 1993.	Halsey, Stuart & Co., Inc.
60,000,000	B. F. Goodrich Co. debenture 4⅝'s, due in 1985.	Goldman, Sachs & Co.
60,000,000	Midwestern Gas Transmission Co. first-mortgage 5¾'s, due in 1980 (with warrants).	Stone & Webster Securities Corp.; White, Weld & Co.; Halsey, Stuart & Co., Inc.
60,000,000†	New York Telephone Co. refunding 4⅝'s, due in 1997.	Halsey, Stuart & Co., Inc.
60,000,000†	Pacific Gas & Electric Corp. first-refunding 4⅝'s, due in 1992.	First Boston Corp.; Halsey, Stuart & Co., Inc.
60,000,000†	Southern California Edison Co. first-refunding 4⅜'s, due in 1985.	First Boston Corp.; Dean Witter & Co.
60,000,000	Youngstown Sheet & Tube Co. first 4½'s, due in 1990.	Kuhn, Loeb & Co.; Smith, Barney & Co.

* *Investment Dealers' Digest*, February 6, 1961, sec. 2, pp. 12–14.
† Competitive bidding.

Prior to the reform of securities practices in the thirties, security affiliates of large commercial banks played a prominent part in the investment banking field. Two examples are the Guaranty Company and the National City Company, which were controlled by the Guaranty Trust

Company and the National City Bank, respectively. Under the Banking Act of 1933, the separation of commercial and investment banking activities was required. To show the effects of this legislation upon the companies affected, we may note the changes in the operations of J. P. Morgan and Company, which was widely recognized as an investment and commercial bank. In 1935, interests formerly associated with J. P. Morgan and Company organized the existing firm of Morgan, Stanley and Company, which is an investment firm operating mainly on a wholesale basis. J. P. Morgan and Company, proper, continued functioning until 1940 as a privately operated commercial bank accepting deposits and making business loans; in that year, it incorporated under a state charter to obtain more favorable tax rates and greater flexibility in its capitalization.

In earlier years, there was a tendency to classify investment banking institutions along the following lines: (1) wholesale investment bankers, (2) retail investment bankers, and (3) those combining the wholesale and retail functions. The terms are largely self-descriptive of the scope and nature of their activities. Today, this classification is not nearly as applicable, although some investment bankers do confine the major part of their operations to underwriting, as distinguished from sale of the securities to the investors. Also, in connection with the latter, selling groups are organized on both an informal and formal basis to facilitate the distribution. To mention some of the more prominent investment banking firms, Table 34 shows those organizations that participated in a managerial capacity in connection with the 15 largest public security offerings in 1960. For all public offerings of securities in 1960, a total of 499 investment banking firms appeared in a management capacity, either singly or jointly.[9]

CRITERIA OF ACCEPTABLE SECURITY ISSUES

One of the primary functions of investment banking is to determine which issues are acceptable for public distribution. If we ignore for the present the details involved in obtaining the desired information, it may be said that at least the following items must be considered by the investment banker before acceptance of an issue: (1) What is the nature of the industry? (2) What is the standing of the corporation within the industry? (3) Are the securities adaptable to current demand in the investment market?

THE NATURE OF THE INDUSTRY

The priceless asset of any corporation is public confidence in its operations. This is particularly true of investment banking organizations because the ultimate test of the securities that they sell is their soundness.

[9] *Investment Dealers' Digest*, February 6, 1961, sec. 2, p. 7.

Consequently, the better-known investment banks shy away from the securities of industries that are considered to be highly speculative in nature. Instead, they are interested primarily in the securities of industries that are well-established and have reasonably long and satisfactory histories. It is for this reason that new ventures and small companies which lack public recognition have difficulty in obtaining the services of investment banking houses with national standing. At the same time, it may be observed that the dividing line between stability and uncertainty is no longer as pronounced as it appeared to be prior to the thirties. Indeed, it is possible that the momentous changes in recent years may serve to diminish the force of past entrenchment and to give added emphasis to flexibility as a factor in investment security. Also, the Securities Act of 1933 has placed a premium on the disclosure of facts, which may accentuate the responsibilities of the investor while weakening those of the selling intermediary.

Despite the complexity of current economic conditions and the cloudy character of the future outlook, the first requirement of investment security is found in the nature of the industry in which a corporation operates. Hence, it is not surprising that banking houses which prize their prestige and public standing generally avoid the handling of securities of companies that are not in well-established fields of economic activity. Many such banks delayed participation in the sale of the securities of motion-picture enterprises, aviation companies, etc., until the industries proved their status. Then, an analysis was made of their past record; and consideration was given to the assurance of future outlook. Strangely illustrative of the force of the industry factor is the record of railroad companies; despite the many failures, the belief that the industry is permanent in nature has always attracted investment support. However, it should be observed that banking firms which look more particularly to quick profits may place little weight on the nature of the industry; also, to support their position, they may contend that such analysis is the responsibility of the investor.

THE STATUS OF THE INDIVIDUAL COMPANY

Not only should the industry be adaptable to the foregoing requirements, but the specific unit within the field should also possess the proper qualifications. In the past, most banking houses assembled comprehensive information relating to the financial position of the company to determine whether the proposed security offering met their standards. Most of the data were believed to be confidential in nature and were not given general circulation. Today, formal registration statements are required under the Securities Act of 1933 and are readily available for public inspection. Also, the essential facts and data are incorporated into a prospectus, which is given general distribution. By this means, investors may give careful

scrutiny to the following types of information relating to any company offering a new security issue:

1. The corporation's history.
2. Description of its business.
3. Details relating to its organization.
4. A complete description of its properties.
5. Full information on all its outstanding securities, their rights, privileges, and voting power.
6. Description of the proposed issue and the intended use of the funds from the issue.
7. Complete information concerning the relationships prevailing among the officers, directors, underwriters, and trustees, as well as details relating to the underwriting agreement.

IS THE SECURITY ADAPTABLE TO CAPITAL-MARKET CONDITIONS?

One of the most practical contributions the investment banker is able to make is advice as to the type of security which is best suited for raising funds at the particular time. To obtain lowest-cost financing, it is necessary to harmonize the security with prevailing money-market conditions. In periods of high interest rates, long-term bonds are usually undesirable; and short-term obligations or stocks become the prevailing type of issue. Conversely, in periods of low interest rates, long-term bonds may be issued advantageously; and extensive refunding operations should be undertaken.

The desirable policy from the point of view of the cost of capital and the way a particular issue fits into a corporation's financial structure may not always be possible because of temporary, adverse market conditions. Where this is true, it may be preferable to issue a short-term, rather than a long-term, security. Similarly, it may prove profitable at times to incorporate conversion or participation privileges in bonds and preferred stocks, although at other times the market might show little interest in such features.[10] In any event, the intimate association of the investment banker with capital-market conditions puts him in a position to give valuable assistance to the corporation in preparing the type of security which should obtain capital at the best price.

COST OF FLOATING SECURITIES

A wide variety of costs are entailed by issuers in the floating of securities, such as: SEC registration fees, federal issuance taxes, mortgage recording fees, printing and engraving costs, trustees' charges for authentication of the securities, legal counsel fees and expenses, accountants' fees and expenses, and other miscellaneous items. Printing and engraving

---

[10] See *Business Week*, November 30, 1940, pp. 45–46, for the experiences of the Youngstown Sheet and Tube Company from 1933 to 1940.

costs, alone, may amount to one-half of one per cent of the principal amount for a small issue. The costs are also affected by the complexity of the security offering; for example, a bond secured by a mortgage would require more detailed work than an unsecured bond. Again, the costs of handling the issuance of additional common stock where the stockholders are given pre-emptive rights would be more complicated and costly than an offering of preferred stock.

Even more significant than the costs relating to the form and preparation of a new security offering are the commissions and discounts allowed to the bankers who underwrite or sell the issue. Current aggregate statistics covering the costs of floating securities for cash sale through investment bankers are not readily available, but it is likely that the study of such offerings made by the Securities and Exchange Commission for the period from 1945 to 1949 may be indicative of the present pattern.[11] The costs of flotations were related to the type of security and the size of the issue; in a later analysis, consideration was given to the risk rating of the securities. In summary, the following findings were made:

Type of Security. In terms of percentage of the gross proceeds, the *total* costs of flotation were as follows: bonds, 1.30 per cent; preferred stock, 4.21 per cent; and common stock, 9.61 per cent. In each category the largest element of cost was commissions and discounts, and their relative importance may be seen by deducting the following *other* costs from the previously reported totals: bonds, 0.52 per cent; preferred stock, 0.75 per cent; and common stock, 1.14 per cent.[12]

Size of Issue. For bonds, the total costs of flotation ranged from 1.04 per cent of the gross proceeds raised by large issues ($50,000,000 and over) to 10.21 per cent for small issues (less than $500,000); in the same size categories for preferred stock, the respective percentages were 2.33 per cent and 19.13 per cent. For common stock, the percentages ranged from 8.30 per cent of the proceeds from issues of $20,000,000 to $50,000,000 (no issue was in excess of the latter figure) to 24.13 per cent for issues of less than $500,000.[13]

Risk Rating. In this instance only bonds were classified on a risk basis, and, for the period 1948–1950, the flotation costs ranged from 0.5 per cent for bonds of the first and second grades to 5.0 per cent for bonds below the fifth grade.[14]

Allowances to investment bankers for their services in the underwriting of security issues vary according to the conditions described above and, in addition, they are influenced by the state of the capital market. On occasion, there may be a dearth of new financing; and the competition or search for business may become very keen. In one exceptional instance, a banking firm paid the corporation for the right to sell a security offer-

---

[11] Securities and Exchange Commission, *Cost of Flotation, 1945–1949* (February, 1951).

[12] *Ibid.*, p. 17.

[13] *Ibid.*, p. 18.

[14] Securities and Exchange Commission, *Sixteenth Annual Report for the Fiscal Year Ended June 30, 1950* (Washington, D.C.: U.S. Government Printing Office), p. 178.

ing.[15] It was characterized as a "move . . . without precedent in the history of American finance." The nature and intensity of competition is, of course, moderated under opposite conditions and is further influenced by the different arrangements which may be established for the sale of securities.

ARRANGEMENTS FOR SALE OF SECURITIES

In making arrangements for the sale of securities, corporations may be expected to seek the most advantageous basis for raising funds. Railroads and public utilities must call for competitive bids unless they are authorized to proceed otherwise,[16] but industrial and miscellaneous companies are generally free to consider all three methods of sale: (1) agency or commission basis, (2) competitive bid, and (3) negotiated sale.

The decision as to which of the methods will be used is affected by the investment rating of the securities being offered, as well as by capital-market conditions. Any weakness on either count would naturally cause investment banking houses to pursue a course of minimizing their risks, and their interest in security offerings would be moderated accordingly. On the other hand, corporations of recognized standing are eagerly sought by the bankers, particularly in times of easy credit; indeed, under such conditions, they may forego the formalities of underwriting and handle the security issue on a low fee basis in order to reduce the costs to the issuer. Usually, however, most corporations prefer to have the certainty of a definite underwriting commitment. Each of the three arrangements for sale may now be discussed briefly.

THE COMMISSION PLAN

Under the commission plan, the banking house or other representative simply acts as an agent in the sale of the securities. In effect, the security offering is not underwritten, since the banker agrees only to exert his best efforts to float the issue and is paid a commission on the securities actually

[15] See *Wall Street Journal*, July 5, 1947, p. 8, reporting that Halsey, Stuart & Co., Inc., paid the Public Service Company of Colorado $100 for underwriting its $7,000,000 issue of 3 per cent convertible debentures, due in 1962. It was indicated that Halsey, Stuart & Co., Inc., might "realize a profit in the neighborhood of $25,000" by its purchase at par of the bonds not subscribed for by the stockholders and their subsequent sale at approximately 112¾.

[16] Except for issues of less than $1,000,000 and exchanges, railroads must use competitive bidding, unless otherwise approved by the Interstate Commerce Commission. For companies subject to the Public Utility Holding Company Act of 1935, competitive bidding is mandatory unless waived by the Securities and Exchange Commission; also, its use is required in 14 states and the District of Columbia (these states have more than 40 per cent of the total population); and the power to require it exists in 18 other states. See *State Commission Jurisdiction and Regulation of Electric and Gas Utilities* (Document FPC S-60 [Washington, D.C.: Federal Power Commission, 1948]), pp. 6–7.

sold. Current statistics covering the aggregate volume of securities sold on this basis are not readily available, but the data for the fiscal year ended June 30, 1953, may be indicative; during that period, some $1,654,-290,000 of the registered securities proposed for cash sale were offered on a commission basis as compared with $4,029,756,000 for purchase and resale.[17]

Securities with more than average risk are generally sold on a strict, commission arrangement because it is impractical for bankers to assume the responsibility of outright underwriting. Usually the offerings are relatively small in amount, and often are those of comparatively new companies. An example is the sale in mid-1960 of $76,500 convertible debenture 6½'s, due in 1965, and 102,000 shares of common stock (par $0.10) of Glass Magic Boats, Inc. in units consisting of $51.00 principal amount of debentures and 68 shares of common stock at a unit price of $102.00. The gross spread between the sales price and the amount to be realized by the company is $12.75, of which $6.25 represents concessions to secondary dealers.[18]

A form of the commission plan is not uncommon in the case of stock offerings and the exchange of securities where there is solicitation of the existing holders of record. For instance, in 1960, the Waltham Precision Instrument Company used the services of an investment banker as a "dealer-manager" in offering 700,000 shares of common stock to stockholders of record (June 30, 1960) at a price of $2.25 per share. Soliciting dealers were paid a fee of $0.10 per share on normal or primary subscriptions (the rights permitted the purchase of one new share for each 5 outstanding shares) and $0.15 per share on oversubscriptions.[19]

Illustrative of exchange transactions is the financing effected by the West Florida Natural Gas Company in early 1960. Holders of the outstanding debenture 6's, due in 1973, were offered in exchange for each $100.00 of these bonds units consisting of: $50.00 subordinated debenture 7½'s, due in 1990; 5 shares of 7½ per cent preferred stock; and 5 shares of class A common stock (par $1.00). Soliciting dealers were paid a fee of $2.00 for each $100.00 of debentures exchanged; any unexchanged units were to be offered to the general public.[20]

On rare occasion, the commission plan may also be used for the sale of securities because they are deemed "so good" that they may not need the protection of formal underwriting. To illustrate, $50,000,000 debentures of the Socony-Vacuum Oil Company were sold in 1935 by Salomon Bros. & Hutzler as agent at a commission of four-tenths of one per cent.

---

[17] Securities and Exchange Commission, *Nineteenth Annual Report for the Fiscal Year Ended June 30, 1953*, p. 4.

[18] *Investment Dealers' Digest*, July 11, 1960, p. 25.

[19] *Ibid.*, p. 100.

[20] *Investment Dealers' Digest*, February 8, 1960, p. 26.

PURCHASE AND RESALE—NEGOTIATED BASIS

Under the outright purchase plan, the investment banking house assumes the role of a securities merchant and buys the securities outright from the corporation at an agreed price. The source of profit to the banking house is the differential between the purchase price and the price at which it sells the securities. Under the bid plan, the securities are also bought outright; but the present method differs in that the relationship between the banking element and the business corporation is often on a permanent basis, and the terms of the transaction are arrived at through negotiation rather than competitive bidding. A friendly and fairly continuous relationship prevails both in times of normal business and in times of financial stress. Under these circumstances, when the corporation gets into difficulty, the banking house usually deems it part of its obligation to assist in any necessary financial reorganization, often regardless of its economic advisability. However, critics of investment banking practices contend that the real reason for banker participation in reorganization is to take advantage of the opportunity to gain control of the reorganized company and to realize various fees and profits.

Permanent ties between banking houses and the corporation raise several fundamental questions as to their propriety in terms of financial and investment principles. Can a corporation that has failed or fallen into a difficult financial condition offer really high-grade investments to the public? If it cannot do so, should the investment banker urge such issues upon the investing public? Of course, under some circumstances, the investment banker may personally carry a portion of the securities through a long period of uncertainty; and, in most cases, the new issues put out by the reorganized corporation are primarily for exchange purposes. The old security holders usually receive new securities bearing a lower rate of interest or receive junior equities or stock in exchange for the original issues. Nevertheless, there is always the risk that the practice of banking houses handling securities of troubled corporations which they have financed over a period of years may result in the sale of issues of dubious value. The extent to which this may be possible has undoubtedly been reduced by the new security regulations. The fact remains, however, that issues have been distributed from time to time which would not have been underwritten if it were not for the implied obligation arising out of a permanent financial relationship.

Our perspective in appraising the problem may be clarified by noting the relations between a person or business firm and a commercial bank. Usually, a single bank (or several when warranted by volume) is chosen; and the relationship is intended to be fairly permanent, being broken only by dissatisfaction or for various other reasons. Somewhat the same thought is applied in selecting an investment banking firm which would be presumed to serve at all times as the financial advisor of a corporation

However, it is obvious that the activities of security flotation are not nearly as continuous as those in commercial banking. As a consequence, the merits of a permanent connection as compared with those of competitive bidding have attracted considerable debate, as may be seen in the later discussion of the bid plan.

The support of an investment banking firm may be sought even for offerings made to existing security holders; in technical terms, the underwriters serve on a "stand-by" basis. To note the arrangement in its practical setting, we may refer to the convertible subordinated debenture 4¾'s, due in 1980, of Bausch & Lomb, Inc. which were issued in 1960. The bonds were offered at a price of $100.00 to the common stockholders on the basis of $100.00 principal value of bonds for each 31 shares of stock. The total offering of $7,038,600 was underwritten by Stone & Webster Securities Corporation for a gross fee of $1.80 per $100.00 of debentures. Of the total amount, the exercise of rights accounted for $6,804,800, including $2,906,700 arising out of rights purchased by the underwriters. After the expiration of the rights period, the underwriter sold $224,500 to the public at a price of $112.00.[21]

PURCHASE AND RESALE—BID PLAN

Under the bid arrangement, the proposed security issue is offered for sale to competing groups and is sold to the one making the most advantageous bid. To indicate the extent of its use, the number and volume of negotiated underwritings may be compared with those on a competitive basis as shown in Table 35. Practically all the competitive bidding is found in the utility and railroad companies, which, as noted previously, are generally required to use this plan for the sale of their securities. Compulsory bidding is also a feature of state and municipal bond issues.

In the absence of legal requirement, the competitive bid is not ordinarily used; and there appears to be a marked preference for the negotiated plan of sale, or where possible, the direct placement of securities. Such is the case in the industrial field. Since it is reasonable to assume that competition would result in the lowest costs, we may consider the opposition to its use. Most investment banking firms would naturally prefer negotiation in order to avoid the pressures of competition, but it is not so easy to appreciate the attitude of the companies that are making use of the services. The reasons offered are various, but among the most important are the following:

Lack of Permanent Relationship. The bid plan is not conducive to the

---

[21] During such "stand-by" transactions, the underwriters may "lay off" or sell securities before the expiration of the rights. In this case, $2,916,000's worth was "laid off" at prices ranging from 110½ to 114; of this amount, $2,906,700 was covered by means of purchasing rights in order to obtain the requisite securities. (See *Investment Dealers' Digest,* August 1, 1960, sec. 2, p. 162.)

establishment of permanent relationships between banking houses and business corporations. Many people believe that a well-established connection with a prominent banking house is of material advantage to the business corporation.

Lower Standards. It is commonly believed that the bid plan may result in favoring banking houses of lower standards and that emphasis would be placed unduly upon the price, or yield rate, of the security instead of upon its over-all qualitative features. Eventually, these weaknesses would mean greater losses to the investor. Those who advance these views believe that competitive bidding is incompatible with the quality and standards required to build the long-term confidence which is essential to sound investment.

TABLE 35

SUMMARY STATEMENT OF NEGOTIATED AND COMPETITIVE UNDERWRITINGS IN 1960*

(Amount in Thousands)

Type of Security	Negotiated		Competitive		Total	
	Number	Amount	Number	Amount	Number	Amount
Bonds	219	$2,488,702	118	$2,627,292	337	$5,115,994
Preferred stock	36	144,761	3	23,115	39	167,876
Common stock	857	1,806,724	7	96,235	864	1,902,959
Total	1,112	$4,440,187	128	$2,746,642	1,240	$7,186,829

* Source: *Investment Dealers' Digest*, February 6, 1961, sec. 2, p. 206.

Adaptability. Although the bid plan may be applicable to certain supervised fields which are susceptible to governmental regulation, it is contended that the diversified character of the industrial field is such as to make the bid plan impractical.

Expediency. Conditions of expediency also tend to discourage the extension of competitive bidding. There exists a rather close community of interest among leading banking houses which results in a reduction of competitive spirit in submitting bids. In the second place, many large banking houses have obtained considerable business because of their representation upon many boards of directors.

Regulation and Investigation. Banking houses naturally investigate a security issue quite thoroughly before undertaking its distribution or before bidding for the issue. While the corporation would be required to produce a great deal of information needed in making the analysis, the banking houses would still find it necessary to do considerable amounts of industrial research in order to determine the quality of the issue and the price they should pay. Under the permanent arrangement, duplication of investigation would be avoided; and it is claimed that the resulting savings would enable the corporation to finance at lower rates.

As stated previously, competitive bidding is generally required by the Securities and Exchange Commission in the case of public-utility issues subject to its jurisdiction. In the fiscal year ended June 30, 1960, of the thirty issues of long-term debt and stocks for an aggregate amount of $554,000,000, all except two issues totaling $44,000,000 were issued on a competitive-bid basis. For the cumulative period from the date of the competitive rule, May 7, 1941 to June 30, 1960, some 795 issues for $11,468,000,000 were sold at competitive bidding, and exceptions to the rule were approved for 226 issues with a sales value of $2,355,000,000.[22]

Exceptions to the competitive bidding requirement may be granted for small issues, for sales to existing security holders pursuant to pre-emptive rights or in connection with corporate reorganization, or for other compelling reasons. Illustrative of the last item is the approval in fiscal 1960 of the sale of first-mortgage 5 per cent bonds, due in 1982, of the Yankee Atomic Electric Company in amounts up to $20,000,000; not only were bond-market conditions uncertain at the time, but, in addition, the project to be financed was deemed to be of a unique nature. Under the circumstances, approval was given to an agreement permitting purchase by ten insurance companies without competitive bidding.[23]

The emphasis given to competitive bidding by the Securities and Exchange Commission arises out of the belief that some such requirement is necessary to comply with the provisions of the Public Utility Holding Company Act of 1935. Here, the principle of "arm's-length bargaining" is introduced as being essential to prevent the "restraint of free and independent competition."[24] Initially, the Commission adopted a rule (U-12F-2) prohibiting the payment of any fee to affiliated interests in the absence of competitive bidding except when the participation in the underwriting was not more than 5 per cent and the same as that paid to nonaffiliated underwriters. Later, a more stringent requirement for competitive bidding was adopted under the entitlement Rule U-50.

Most of the banking houses interposed violent objections to the adoption of open bidding, contending that it was not required by the act and that the effects would be harmful to their business as well as to borrowing institutions. Possibly this burst of reaction was the usual exaggeration of anticipation as contrasted with later reality, because there is increasing acceptance of the principle with accumulating experience. Several interesting problems have developed, such as the keeping of the members of a syndicated group together in the face of open bidding and the treatment of members of losing groups. However, these difficulties are being worked out; and, undoubtedly, increasing use of the practice will probably show need for concessions on both sides.

[22] Securities and Exchange Commission, *Twenty-sixth Annual Report for the Fiscal Year Ended June 30, 1960*, p. 147.

[23] *Ibid.*

[24] See Public Utility Holding Company Act of 1935, sec. 1 (b) (2) and sec. 12 (f).

To show the keenness of competition for the purchase of a new issue of accepted investment merit, we may note in Table 36 the details relating to the bidding for the debentures of the Sierra Pacific Power Company, due in 1985, in the face amount of $3,500,000. The company accepted the bid of Halsey, Stuart & Co. and its associates, and the bonds were offered for sale to the public at 101.687 to yield 5.50 per cent. By deducting the price paid to the Sierra Pacific Power Company, it will be noted that the underwriters' gross spread was 1.497; of this, secondary dealers in the issue were allowed a concession of ⅝'s.

As stated previously, competitive bidding is not yet used to any extent in the handling of industrial issues; and some observers contend that the principle is not applicable in this field. It is pointed out that open bid-

TABLE 36

BIDS SUBMITTED FOR PURCHASE OF THE DEBENTURES OF THE SIERRA PACIFIC POWER COMPANY—1960*

Bidder	Annual Interest Rate	Price to Sierra Company—Percentage of Principal	Annual Cost to Sierra Company (Percentage)
Halsey, Stuart & Co., and others†	5⅝	100.19	5.6108
Salomon Bros. & Hutzler	5¾	100.111	5.7416
Kidder, Peabody & Co.—White, Weld & Co. (joint)	5⅞	100.10	5.7912
Stone & Webster Securities Corp.—Dean Witter & Co. (joint)	5⅞	100.03	5.8727

* Source: *Investment Dealers' Digest*, July 11, 1960, p. 10.
† Ten other investment banking firms.

ding can be useful only when a certain amount of standardization exists and when the securities are very high grade. There is some merit in this position because the element of variety necessarily destroys the common denominator which is a basis for bidding by different groups.[25] For this reason, the wide range of risks and other varying qualities of the many segments of the industrial area may prevent any widespread use in this field. This would be especially true of the small and isolated companies without sufficient attraction to command the presence of banking houses at the bidding. Under the circumstances, small business institutions are compelled to hire special agents or to make other arrangements which fit their particular needs. When agents are hired, it is customary to adopt the commission plan which was previously described.

THE SYNDICATE ARRANGEMENT

A common feature in the distribution of securities is the creation of a syndicate that consists of several investment banking firms which join

[25] However, the Home Owners' Loan Corporation was successful in using the bid method in placing its fire insurance contract, although many factors were involved.

interests in the handling of a security issue. This form of organization is commonly referred to as an "underwriting syndicate." Because the word "underwriting" is used in a broad sense, its exact and correct meaning should be understood. Fundamentally, it means the assumption of the risk involved in connection with certain contingencies. Thus, fire insurance companies underwrite the possible loss arising through fire; life insurance companies assume the financial losses arising as a result of death; and in the case of security offerings, the underwriters guarantee the raising of a specific amount of capital funds. In the strictest sense of the word, an underwriting syndicate in the case of securities offerings would be one that assumes the risks arising out of the failure of a corporation to raise its capital funds through some other means, such as the issue of stock rights or the direct public offering of the securities by the corporation. However, in practice, the term is rather loosely applied to both purchasing and selling syndicates and should be so understood.

The syndicate arrangement is a convenient one for the handling of security offerings, for a number of reasons. First, it is a means of mobilizing many scattered firms doing business throughout the entire country. In 1960, some 499 investment banking firms acted either singly or as co-managers of 1,240 public offerings for a total amount of $7,186,828,234.[26] Second, the size of some issues is too large for a single banking house to handle conveniently. Third, participation in a number of offerings results in diversification of risk and enables the participating firms to offer a more representative list of securities to their investment clientele.

Syndicate Organization. While all the risks are assumed by the group as a whole, the negotiations with the corporation are conducted by a single banker, who is usually designated in the syndicate agreement as the representative of the syndicate. In practice, the representative is more commonly known as the head or manager of the syndicate. In large issues, there is likely to be joint management; but, in either event, all the expected tasks of a directing head are performed. Besides the negotiations with the corporation, there are various other duties: investigation of the issuing corporation's record, consideration of the terms and amount of the security issue, supervision of the preparation of the registration statement and prospectus, and general direction of the administrative affairs of the syndicate.

The last-named duty embraces a wide variety of powers, giving the syndicate representative such authorities as the following:[27]

1. *Public offering.* "You are authorized, in your sole discretion, to make a public offering . . . on the effective date . . . or as soon thereafter as in your judgment shall be practicable (but not later than the third full business day thereafter, unless you shall have obtained the consent of other

[26] *Investment Dealers' Digest*, February 6, 1961, sec. 2, pp. 7, 16.

[27] "Agreement among Purchasers" covering underwriting of 30,000 shares of cumulative preferred stock of Metropolitan Edison Company, April 3, 1950, p. 3.

Purchasers who together with yourselves shall have agreed . . . to purchase . . . more than 50% of the total number of shares of Stock) and in any event not later than the ninth day following the . . . opening of bids. . . ."

2. *Details of offering.* "We authorize you to act as Managers of the offering, and to take such action as you think advisable in all matters pertaining to the public offering of the Stock."
3. *Sale of the securities.* "We authorize you to reserve for sale and to sell for our account to retail purchasers such Stock purchased by us from the Company as you shall determine. Reservations and sales of Stock to retail purchasers shall be approximately proportionate for all purchasers."

Allotments and Financing. Members of the syndicate are allotted, or agree to accept, a fixed participation in the underwriting. In effect, they meet this obligation by purchase of the securities. Failure to meet his quota by any one participant is regarded as a "cardinal sin," and such a condition is practically unknown. However, if the distribution as a whole is unsuccessful,[28] the syndicate members are responsible for the unsold portion of their allotments. To consider the remote contingency of a default by one or more syndicate members, it is generally provided that the other members are not released from their obligations. However, it is stipulated that the members shall not be regarded as partners and that the liabilities "are several, and not joint."[29]

Financing of the securities preliminary to their sale depends upon the time at which delivery of the funds must be made to the issuing corporation and the sufficiency of funds of the syndicate members. Under competitive bidding, it is generally necessary to provide the funds before sale of the securities is effected; and this is often true of negotiated transactions. In either event, the formal agreement among the underwriters makes provision for this item:

> We authorize you, as our Representatives, to arrange loans for our account and to advance your own funds on our behalf as you may deem necessary or advisable in connection with the purchase of any of the Stock by us . . . and to pledge or hold as security therefor all or any part of the Stock which we shall have purchased or agreed to purchase. . . . Any lending bank is hereby authorized to accept your instructions as to the disposition of the proceeds of any such loan or loans.[30]

Selling the Securities. In earlier years, the purchase syndicate was usually a comparatively small group; and most of the selling was done through a selling syndicate or group. Today, selling syndicates and groups are still organized, but there is less need for them under current practices. The originating syndicate may consist of a large number of

---

[28] See p. 377 for an example; also, it was reported that of the $30,000,000 first-mortgage 2¾'s, due in 1985, of the Potomac Electric Power Company, offered in May, 1950, only about one-third was placed by the syndicate during the prescribed offering period.

[29] "Agreement among Purchasers," *op. cit.*, p. 6.

[30] *Ibid.*, p. 4.

scattered firms providing the outlets for national distribution; for example, there were 117 members in the group underwriting the sale of 541,464 shares of common stock of the Pacific Power and Light Company in July, 1951. At the same time, it should be observed that the proportion of selling by members of the syndicate may vary from their quota of participation in the underwriting. Such houses as Morgan, Stanley and Company; Kuhn, Loeb and Company; and Dillon, Read and Company confine their operations mainly to underwriting and are, in effect, wholesalers. Other banking firms—Halsey, Stuart & Co., Inc.; First Boston Corporation; Blyth & Co., Inc.; and a number of others—have extensive field offices which enable them to proceed with final sale to the investor. Because of this difference in organization, the sale of the securities need not be in the same proportion as the participation in the underwriting.

TABLE 37

ILLUSTRATIVE SECURITY OFFERINGS—EARLY 1961*

Issue	Offering Price	Yield Percentage	Gross Spread	Dealers' Concessions
Puget Sound Power & Light Co. first-mortgage 4⅝'s, due in 1991	99.59	4.65	0.78	0.25
Portland Terminal Co. first-mortgage 6¼'s, due in 1986	98.75	6.35	4.00	2.50
Southern Co. common stock†	50.00	...	1.38	0.375
West Texas Utilities Co. first-mortgage 4⅝'s, due in 1991†	102.547	4.47	0.737	0.25
Chesapeake & Potomac Telephone Co. debenture 4⅜'s, due in 1998†	101.382	4.30	0.793	0.375
General Bowling Corp. common stock	5.00	...	0.625	0.375

* Source: *Investment Dealers' Digest*, February 20, 1961, pp. 54–58.
† Awarded by competitive bidding.

Also, as noted elsewhere, sales may be made through independent security dealers and brokerage houses by allowing them concessions on the offering price to the investors.

Syndicate Profit Margins. The profits of syndicate members and individual underwriters, in general, are obtained in the same manner as the distribution of any commodity, viz., by the markup process. The purchasing syndicate buys the securities from the corporation for less than the public offering price and passes on a portion of this difference to the selling dealers. To visualize the nature of the risks assumed as well as the profit potential, we may note the examples presented in Table 37.

Analysis of the details presented in Table 37 prompts further brief observations. In the case of negotiated issues, the spread between the offering price to the public and the amount realized by the issuer is determined readily by agreement between the purchasing syndicate and the issuer. For issues placed by means of competitive bidding, the syndicate deter-

mines for itself the spread which is necessary to cover the expenses and concessions to dealers. In either case, the spread will necessarily vary with the size of the issue and the readiness of salability in the market. Large issues can be handled at a lower discount than smaller issues; and, as noted earlier, issues of the larger, better-known corporations can be sold more easily than those of the relatively unfamiliar companies.

THE SUMMARY PICTURE

While we have given major attention throughout this chapter to public offerings, we must keep in mind the prominent part now played by the private placement of securities. Large institutional investors, particularly life insurance companies, have naturally sought to enlarge their opportunities for the investment of their funds; often they are favored by preferential income tax treatment and can move with directness and speed. In a sense, institutional investors may be said to have a first lien on American industry.

High-grade industrial bonds provide the core of private placements, since practically all railroad bonds and a large part of the utility bonds are sold by competitive bid. Conditions attending competition make difficult the negotiation that accompanies direct placement, and institutional investors generally refrain from bidding. As a result, the relative use of negotiation and competitive bidding for underwritten issues is mainly a product of the comparative volume of industrial and utility financing. In earlier years, competitive bidding was relatively more important because of the vigorous expansion of public utilities; more recently, industrial growth has taken the spotlight and negotiated underwritings are dominant in the sale of new securities.

Besides private placement and underwriting (either by negotiation or competitive bid), corporations may of course issue securities on their own account. Often this may be done when management acquires the stock or assets of other companies as part of an expansion program. Again, as we shall see in the next chapter, the so-called "rights offering" to the existing security holders may be done without the services of investment bankers.

Methods of selling securities will continue to change in response to new conditions, and adjustment of the mechanism of distribution will be revised to meet those demands. For example, investment banking firms have already recognized the importance of direct placement and often promote such transactions as intermediaries, for which they receive a commission or "finder's fee." The use of members of the National Association of Security Dealers, Inc., on a fee or "concession" basis, has increased both for underwriting and for sale by issuers. These changes from earlier practices are significant in many ways; but, in the last analysis, they probably represent a normal evolution of a dynamic society.

QUESTIONS AND PROBLEMS

1. "The sale of securities has many of the basic characteristics found in the sale of goods and services." Discuss the similarities and differences.
2. Discuss the advantages and disadvantages of direct placement of securities.
3. Why is private or direct placement more applicable to bonds than to stocks?
4. Discuss the observation that institutional investors "have in many respects a first lien on American industry."
5. Discuss the social and economic factors in favor of public offerings.
6. Why may there be need to support the market in the case of public offerings?
7. As a general rule, do you think that any selling agency can serve in the role of an unbiased adviser? Can it be avoided?
8. Evaluate the relative importance of the factors affecting the costs of flotation, as discussed on pages 347–49.
9. Comment on the thought that the commission plan may be used because a "security is so good" that it "may not need the protection of formal underwriting." (See p. 350.)
10. Compare the relative merits of the negotiated-sale and competitive-bid plans of arranging for the sale of securities.
11. Do you think that there is more reason to compel the use of competitive bidding in the case of public utilities than of industrials?
12. What are the dangers of "permanent ties between banking houses and corporations"?
13. Refer to Table 37 on page 358 and discuss the following: (*a*) The reasons for the differences in the "gross spread"; (*b*) The meaning of "dealers' concessions."
14. Why is it possible for investment banking firms to conduct their operations on a comparatively small amount of capital?
15. Discuss the nature of syndicates and consider their activities in negotiated transactions as compared with competitive bidding deals.
16. Evaluate the conditions that would affect the decision as to whether a company should sell its own securities or effect a "best-efforts" arrangement with an investment banker.

REFERENCES

Corey, E. Raymond. *Direct Placement of Corporate Securities.* Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1951.

Howell, Paul L. "Competition in the Capital Markets," *Harvard Business Review,* Vol. XXXI, No. 3 (May–June, 1953), pp. 83–93.

McClintock, Franklin T. *Competitive Bidding for New Issues of Securities.* New York: Harriman, Ripley & Co., 1939.

Minot, James J. "An Investment Banker Reflects on His Modern Role in the Economy," *Commercial and Financial Chronicle,* Vol. 189, No. 5818 (February 5, 1959), p. 9.

Robbins, Sidney M. "Competitive Bidding in Sale of Securities," *Harvard Business Review,* Vol. XXVII, No. 5 (September, 1949), pp. 646–64.

Twentieth Century Fund, Inc. *The Security Markets.* New York, 1935.

VALENTINE, ROGER W. "Investment Banking—History and Regulation," and "Investment Banking—Distinctive Features and Recent Developments," chaps. xiv and xv in *American Financial Institutions* (ed. HERBERT V. PROCHNOW). New York: Prentice-Hall, Inc., 1951.

WEAVER, ROBERT A., JR. "Equity Financing for the Small Firm," *Harvard Business Review*, Vol. XXXIV, No. 2 (March–April, 1956), pp. 91–102.

WHITBECK, JOHN M. "Requirements and Advice for a Successful Bond Issue," *Commercial and Financial Chronicle*, Vol. 188, No. 5788 (October 23, 1958), pp. 10, 24–25.

Chapter 19 ►

STOCK RIGHTS AND WARRANTS

BECAUSE OF the keystone position of common stock in the life of a corporation, it is desirable to give careful attention to offerings which have special meaning to both its rights and values. Involved are not only the effects upon the stock, itself, but probably more important, are the reflections upon both corporate and management behavior generally. Intangible though they may be, corporations do become a medium for molding business philosophy and morals. Especially may this be true today when management seems to be emerging into a distinct entity in its own separate capacity.

On the one hand, management is naturally motivated to make financial moves solely for tactical or strategic reasons; on the other hand, there are both legal and traditional obligations to the special welfare of the common stockholders. Granted that there is much overlapping of the two areas of influence, there can be occasional and significant difference between the two objectives. Tangible evidence of the problem may be found by an analysis of the nature of stock rights and in the sale of new common stock or preferred stock and bonds with conversion privileges.

THE NATURE OF STOCK RIGHTS

In its broadest sense, the term "stock rights" would embrace a wide variety of features, as discussed more fully in Chapter 5.[1] At this time, we shall give consideration to the incidents created by new offerings of securities, and particularly by the issuance of additional common stock. Even in this more restricted application, the word "rights" has a dual meaning: first, denoting the intangible privilege a stockholder has to participate in new offerings and, second, being used as the name of the tangible formal certificates that are issued by the corporation. However, the context of discussion should serve to avoid confusion of the meaning.

Looking to the basic nature of stock rights, it would appear that stockholders, wholly aside from legal compunction, should be entitled to the

[1] See pp. 84–87.

opportunity of preserving their position.[2] If new stock is sold without first giving the stockholders the right to participate, their status in the company is inevitably affected. First, they will have fewer votes in relation to the total number of shares outstanding. Granted that many shareholders fail to exercise their franchise privilege, nevertheless it does not follow that others should infringe upon their rights. Second, since the right to buy new stock is usually at a price below the prevailing market price, the latter must necessarily decline after the new shares are issued. The decline in value may be minor and may even be lost in the larger current of stock price movements; but, even so, the stockholders would lose money. Only by the issuance of rights to the old stockholders can they preserve their investment and ownership status.

However, the issuance of rights to the existing stockholders of a large corporation is a time-consuming and inconvenient operation, and to a degree, may conflict with the objectives of efficiency desired by modern management. As a result, it is not surprising that the latter may seek to dispense with the detailed requirements of the pre-emptive rights of shareholders. Since such rights arise out of equitable principles established by common law, their negation or limitation can be effected only by statutory enactment. This has been done in several states,[3] and the Congress of the United States approved similar authority for corporations chartered under the District of Columbia Business Corporation Act. Specifically, the act provides that "The pre-emptive right of a shareholder to acquire additional shares of a corporation may be limited or denied to the extent provided in the articles of incorporation."[4] There are signs that there may be a definite trend toward the limitation of pre-emptive rights which is indicative of the increasing recognition being given to management prerogative.

Because of the importance of the underlying principle and its portent for corporate financing, we may evaluate the rationale of the legislation which permits the curtailment of the pre-emptive right. Particularly may attention be given to the California law which states that "Unless the articles [of incorporation] provide otherwise, the board of directors may issue shares, option rights, or securities having conversion or option rights, without first offering them to shareholders of any class."[5] In a recent case,[6] the court quoted a leading authority who discussed the origin and purport of the California statute. Briefly, the complexity of corporate structures was noted, and it was observed that it could be "impracticable to find any fair basis of apportionment of new shares. . . ." At the same

[2] Preferred stock with full voting and asset participation rights would also be included.

[3] Such as California, Indiana, Ohio, Illinois and Delaware.

[4] Section 23 of Public Law 389, approved June 8, 1954.

[5] California Corporation Code, sec. 1106.

[6] See 9 Cal. Reptr. 207 (January 2, 1961).

time, it was stressed that the law "must not be understood as relieving the directors from the obligation to exercise the utmost good faith and fairness in the issue of 'shares, option rights, or securities having conversion or option rights,' . . . to certain favored persons without obtaining for the corporation the largest return possible. . . ."[7]

Under the foregoing doctrine, shareholders acting in behalf of the corporation are naturally free to bring legal action to challenge the good faith or negligence of the directors. At the same time, the stockholders, themselves, must carry the expense of the proceedings while the directors are free to use corporate funds. Also it is likely that serious abuse would probably lead to increased regulatory controls of new security issues, but this would not afford any protection to those who had already suffered injury.

The importance of the pre-emptive right is dramatically shown in the issuance of rights by Montgomery Ward & Company in 1928. Not only does this case reflect some of the extreme practices of the decade of the twenties, but it also reveals the safeguards provided by the pre-emptive right with respect to voting position and value maintenance. Rights were issued to stockholders on the basis of two new shares for each share of old, the subscription price being $17.50 per share. Were it not for their right to subscribe, the old stockholders would have suffered a serious impairment of their position: (1) on the first day that the stock sold without inclusion of the right privilege, it opened at a price of 129, as compared with a closing price of 334⅞ on the previous day, and (2) with the issuance of two new shares for each one of old, the total votes that could be represented by the latter would be only one-third of the total possible votes. The effect of rights upon the value of stock may be seen in the ensuing analysis of assumed and actual conditions.

THE VALUE OF RIGHTS

While it is possible to relate the right to subscribe to either the new or old stock, it is almost universal practice to associate it with the latter.[8] In other words, its value is expressed in terms of the right that attaches to one old share of stock to subscribe for one new share of stock. To make this clear, if the opportunity were offered to purchase one new share of stock for each 10 shares of old, the holder of 10 shares of old stock would come into the possession of 10 rights. In turn, it would require 10 rights plus the subscription price to acquire one new share of stock. The reader must guard against the easy error of assuming that a single right gives one the privilege of subscribing for stock.

Stock rights are issued in the form of formal certificates which may be

[7] Ballantine & Sterling (1949 Edition), *California Corporation Laws*, pp. 142–43, sec. 104.

[8] Such rights are called "New York rights" and are used almost exclusively. "Philadelphia rights," another type, are based upon the new issue.

bought and sold on the market in about the same manner as securities. Their value depends mainly upon the number required to buy a new share of stock and upon the spread between the market price and the offering price. Their worth may be seen best by noting the change that takes place as a result of issuing new stock. We may assume that the old stock is selling at $90 per share and that the stockholders are given the right to buy one new share at $60 for every 2 shares of stock held. After the issuance of the new stock, it is apparent that there will be 3 shares outstanding for every 2 previously in existence. Accordingly, if the *old* stock was worth $90 per share and a *new* share is sold at $60, the value of any of the shares after the issuance may be determined as follows:

Two old shares at $90	$180
One new share at $60	60
Total value of 3 shares	$240
Value of each share	$ 80

In turn, the old stockholders have the right to buy a share of stock which will be worth $80 for $60 plus 2 rights. The difference of $20 divided by 2 rights should then mean that a single right would be worth $10. To compute the value of the right, the following formula is commonly used:

$$\frac{\text{Market Price (\$90) less Offering Price (\$60)}}{\text{Ratio of Old to New Stock (2) plus New Share (1)}} = \$10$$

In actual practice, the value of a right may not be exactly $10 because of imperfect synchronizing between trading in the stock itself and trading in the rights. Needless to say, the price of the right will also change as the price of stock goes up or down. To test the relationship between the nominal, or computed, value of a right and its market price, we may take an actual case. Stockholders of record as of February 23, 1961, of the American Telephone and Telegraph Company were given the right to buy one new share of stock for $86.00 for every 20 shares owned. On February 24, the stock closed at 114⅝; accordingly, the nominal worth of the right would be determined as follows:

$$\frac{\text{Market Price (\$114⅝) less Offering Price (\$86)}}{\text{Ratio of Old to New Stock (20) plus New Share (1)}} = \$1.364$$

Actually, the right sold at 1^{15}/_{16}$ ($1.9367), the difference probably being caused by the avoidance of commissions, taxes, and miscellaneous costs when acquiring stock by the exchange of rights instead of through brokerage channels.

When the offering price is fixed only slightly below the market price, and if the ratio of old to new stock is relatively high, the value of each right is only fractional. To illustrate, we may refer to the issuance of additional stock by the El Paso Natural Gas Company to holders of record July 26, 1960; the latter were given the right to buy one new share for each 15 shares held at a price of $29.00. At the time, the outstanding stock

was selling on the market at $31\frac{3}{4}$ (range of $31\frac{3}{8}$ to $32\frac{1}{2}$ for the period from July 21 to July 26); in the ensuing rights period which expired on August 11, the price of the rights ranged from a high of $\frac{25}{64}$ to a low of $\frac{9}{64}$. Not surprisingly, the company had the new issue underwritten so that it would be free of any risks that could develop because of any adverse developments in stock market conditions.

RELATIONSHIP BETWEEN NOMINAL AND MARKET VALUE

It should be borne in mind that the so-called "par" or "nominal" value of a right is true at a given moment only and must of necessity fluctuate in response to movements in the price of the stock itself. In turn, it is natural that the market price of the rights should approximate the nominal value because of the market operations of three groups: (1) activities of old stockholders, (2) activities of new stockholders, and (3) activities of speculators.

To illustrate the possible action of these groups we may take the case of the American Telephone and Telegraph Company previously mentioned. On the day before the stock sold ex-rights it closed at a price of $115\frac{3}{4}$, while the rights sold on a w.i. (when issued) basis at $1\frac{1}{2}$. In order to make the point at issue very clear, we may make the extreme assumption that the rights were available at $\frac{1}{2}$. Under these conditions, the following responses may occur (assuming 100-share lots of stock in each instance):

I. Old stockholders		
Sell 100 shares of stock at $115\frac{3}{4}$		$11,575
Less: 100 rights at $\frac{1}{2}$		50
Net stock value		$11,525
To Restore Previous Status:		
Buy 2,000 rights at $\frac{1}{2}$	$1,000	
Subscription price	8,600	9,600
Profit through selling		$ 1,925
II. New stockholders		
Buy 100 shares at $115\frac{3}{4}$		$11,575
Less: Value of 100 rights at $\frac{1}{2}$		50
Net cost of old shares		$11,525
Purchase of Stock through Rights:		
Buy 2,000 rights at $\frac{1}{2}$	$1,000	
Subscription price	8,600	9,600
Savings effected by obtaining stock through rights		$ 1,925
III. Speculators		
Sell short 100 shares at $115\frac{3}{4}$		$11,575
To Cover:		
Buy 2,100 rights* at $\frac{1}{2}$	$1,050	
Subscription price	8,600	9,650
Profit to speculators		$ 1,925

* Two thousand rights to purchase 100 new shares and 100 rights to repay the original loan.

It is apparent that the foregoing operations would automatically tend to eliminate possible arbitraging, and the advantage of buying rights would be eliminated. This would be specifically effected because:

1. The action of the old stockholders would increase the floating supply of stock and thus depress its price. At the same time, the stimulated demand for rights would raise their price.
2. The action of the new stockholders would increase the demand for rights and thus increase their price.
3. The action of speculators would produce results similar to those arising from the action of the old stockholders.

The price of the stock would tend to fall as a result of these operations, while the price of the rights would tend to rise. The movements would continue until normal equilibrium was restored.

"RIGHTS-ON" AND "EX-RIGHTS" PERIODS

Attention must now be called to the fact that rights are issued to holders of record as of a stated date, and the stockholders appearing on the stock books of the corporation as of this date are the recipients of the rights. Prior to this date, any stock which is sold carries with it the privilege to share in the rights. After the date, the rights are separate and distinct; hence, the stock is referred to as "ex-rights." All market transactions in rights during the "rights-on" period must of necessity be on a "when-issued" basis, since the actual rights are issued only as of the record date specified.

At the time that a stock goes "ex-rights," it is logical to expect the price of the stock to decline by the value of the right. As shown in the assumed transaction on page 365, the stock is necessarily diluted by virtue of the new stock being sold at a price lower than the prevailing price of the old stock. The effect is not readily discernible in those cases where rights have a low value but may be seen clearly in the case of the American Telephone and Telegraph Company previously cited. At the expiration of the "rights-on" period, the closing market prices of the stock and rights were as follows:

Stock	115¾
Rights	1½

The following day the stock closed at 113⅛, and the stock exchange quotation reported a net loss for the stock of 1⅛ points. This is accounted for as follows:

Closing price of stock, February 16	115¾
Closing price of rights, February 16	1½
Value of stock, ex-rights	114¼
Closing price of stock, February 17	113⅛
Net decline in stock	1⅛

Besides noting the adjustment in price at the time a stock goes "ex-rights," we may give brief thought to the influence of rights offerings over a longer period of time. Basically it would seem that such offerings should have little effect upon stock prices other than that arising from the dilution caused by the issuance of new stock at a price that is lower than that of the old stock. At the same time, it is known that stock prices do react to the psychology of various items of "news" relating to securities. Particularly is this true in active markets; and, under such conditions, the anticipation of stock rights tends to create a buoyant atmosphere. As a result, new pressures of demand and supply affect the prices of securities.

Illustrative of the foregoing features is the performance of the stock of our subject case—the American Telephone and Telegraph Company. On December 20, 1960, 10,800 shares of stock were sold in the market, and it closed at a price of 96⅛. On the next day, when the public announcement of the rights offering was made, the stock advanced 6⅜ points while the number of shares sold increased to 102,800. Following this dramatic and sudden rise, activity in the stock tended to stabilize; then it rose further in price in keeping with the general movement in the stock market (on March 30, 1961, it closed at 120⅞).

Despite the foregoing, it should be stressed that any generalization about activities arising out of offerings is tenuous, to say the least. For example, on occasion, stocks may decline upon announcement of the rights as a result of the tendency of speculators to sell at the time "good news" is made public. Earlier studies tended to give evidence of such influence, but later findings show that it is difficult to reach any broad conclusion about the reaction to a new stock offering for cash.[9]

Probably the behavior of stock prices under the influence of rights offerings has been affected by the increasing tendency to underwrite the sale of the securities. Specifically, underwriters resort to the so-called "Barry Plan" under which they buy rights on their own account during the rights period. Provision is then made for the sale of the acquired stock away from the market place, i.e., by direct solicitation.

EFFECT OF RIGHTS ON THE BOOK VALUE OF STOCK

A casual reaction to the effect of rights upon the book value of the stock is that their issuance should cause the book value to decrease. This is not necessarily true. The change will depend specifically upon whether the subscription price of the new stock is above or below the book value

---

[9] See studies by Shields & Co., reported in the *Investor*, August, 1951, p. 6 and *Investment Dealers' Digest*, December 19, 1960, sec. 2, pp. 202, 205–6.

of the old stock. If the former is true, then clearly the book value will be increased; and opposite results will appear under the latter condition. This may be seen from the following illustration:

BALANCE SHEET OF THE MAKUP CORPORATION PRIOR TO ISSUANCE OF RIGHTS

ASSETS		LIABILITIES	
Cash	$ 1,000,000	Accounts payable	$ 1,500,000
Other current assets	4,000,000	Other current liabilities	700,000
Fixed and other assets	7,000,000	Capital stock (100,000 shares outstanding)	5,000,000
		Surplus	4,800,000
	$12,000,000		$12,000,000

The book value per share of the foregoing stock is $98 ($5,000,000 capital plus $4,800,000 surplus divided by 100,000, the number of shares outstanding). It may be assumed that the stock is selling in the market at 125 and that the old stockholders are given the right to subscribe to new stock at a price of 110, in the ratio of one new share for each old share held. On this basis, the rights would have a value of $7.50 per share (applying the formula previously developed). If all the rights were exercised, $11,000,000 cash would be added to the treasury of the company; and an additional 100,000 shares of stock would be issued. Applying these changes, the balance sheet would then appear as follows:

BALANCE SHEET OF THE MAKUP CORPORATION AFTER THE ISSUANCE OF RIGHTS

ASSETS		LIABILITIES	
Cash	$12,000,000	Accounts payable	$ 1,500,000
Other current assets	4,000,000	Other current liabilities	700,000
Fixed and other assets	7,000,000	Capital stock (200,000 shares outstanding)	10,000,000*
		Capital surplus or premium	6,000,000
		Surplus	4,800,000
	$23,000,000		$23,000,000

* If the shares had a par value, a premium account would likely be set up, and capital or paid-in surplus could be used if the shares were no-par. The stated value of the stock could also be changed in the process; but for purposes of this illustration, additional changes should not be included.

On the basis of the balance sheet as it appears after the issuance of the rights, it is apparent that the stock would now have a book value of $104 per share ($10,000,000 capital stock plus $6,000,000 capital surplus plus $4,800,000 surplus divided by 200,000, the number of shares outstanding). In contrast, the market value of the stock would tend to diminish at the moment by the value of the right.

RELATIONSHIP BETWEEN PAR VALUE OF STOCK AND STOCK RIGHTS

There is no fundamental economic relationship between stock rights and the par value of stock. Of course, if rights are issued offering stock at a price less than par, the stock is assessable in the same manner as any other new issue. It is therefore obvious that such an issue would normally be avoided.[10] If the stock were no-par, this difficulty would be avoided entirely; and the corporation would be free to set the price according to market conditions.

EFFECT OF RIGHTS ON STOCKHOLDER

What advantage does the existing stockholder have over the outsider? The answer appears to be that he has little, if any, advantage. Of course, as stated previously, rights do enable a stockholder to preserve his position as to control and as to the value of his investment. However, the exercise of the right yields him no gain over any new investor because his old stock declines in value in accordance with the value of the rights. This may be clarified by referring again to the rights of the American Telephone and Telegraph Company described; and we may assume that Mr. X, a stockholder, held twenty shares as of the record date.[11] On February 16, his stock was accordingly worth:

$$20 \times 115\tfrac{3}{4} = \$2{,}315.00$$

Since the stock closed at 113⅛ the following day, the value of X's holdings on February 17 would be (assuming the exercise of the rights to buy one share):

Total value—21 shares at 113⅛	$2,375.63
Less: New investment	86.00
Net value of original holdings	$2,289.63

It will be noted that the value of X's holdings is $25.37 less than the amount prior to the adjustment for the rights; this, of course, is caused by the decline in the market price mentioned on page 367. Moreover it is evident that the stockholder derived no gain from the rights and was simply afforded an opportunity for new investment. This is no particular advantage over prospective stockholders, since the latter may buy the

[10] A. S. Dewing, *Financial Policy of Corporations* (New York: The Ronald Press Co., 1934), p. 1044, mentions an instance of this being done; in 1900, the Western Maryland Railroad offered new stock (par $100) at $50.

[11] To become a stockholder as of the record date, it is necessary to buy stock sufficiently ahead of this time in order to achieve a record status. Normally, stock must be delivered by the fourth business day following its sale.

stock (ex-rights) at the old market price less the value of the right (ignoring price changes accruing from other causes).[12]

Similarly, it would follow that if the stockholder sold his rights, the proceeds would not constitute income but instead would be primarily a return of principal. In this respect, stock rights are regarded in much the same light as stock dividends. This treatment of stock rights is followed by the Internal Revenue Service in connection with the administration of the income tax law.[13] Here it is recognized that the rights are not taxable income, although some gain or loss may arise through the sale of the rights. To determine the net effect, the proper proportion of the total cost (principal investment) is assigned to the rights and is deducted from the proceeds created by the sale. Gain or loss is thus determined in exactly the same manner as in the sale of the securities themselves.

While rights do not serve as a source of income to the stockholder, they are nevertheless a convenient means of corporate financing and may be justified on the basis of policy, especially in view of the following considerations: (1) they provide an economical and reliable source of capital funds for the corporation, and (2) they offer an outlet for the investment of new funds on the part of the investor. On these terms, the rights simply represent a value-for-value transaction between the corporation and the investor. True, there is the privilege of prior subscription;[14] but this does not necessarily imply the bequest of anything of value to the stockholder.

RIGHT TO SUBSCRIBE TO CONVERTIBLE ISSUES

Since the underlying purpose of rights is to give the residual equity elements the opportunity to protect their position, any new offerings of convertible bonds or convertible preferred stocks are equally subject to the requirement that priority of subscription be given to the holders of common stock. While the conversion feature delays the ultimate effects, its exercise can only result in the dilution of the stock position. The rate of conversion may be so gradual or so incidental that measurement of the effects may not be detected quickly in market performance, but its background influence is inescapable. Over a period of time, the resulting increase in the number of outstanding shares of stock will be reflected in earnings per share as well as in other ways—weakening the control of the old stockholders and diluting their equity in the surplus. To protect the

---

[12] In an article by Frederick Warner entitled "Composite Loss to Investors in New Stock Issues," *Annalist*, June 21, 1935, it is pointed out that new offerings may easily be the source of losses since the corporations will obviously offer the stock when the market is most favorable.

[13] *Federal Tax Regulations*, sec. 1.305-1.

[14] To be more correct, this is a pre-emptive right of the stockholder and not merely a privilege.

common stock against this contingency, or at least to give the common stockholders a chance to avoid the risk, rights are usually issued to the common stock giving it the privilege to subscribe to the convertible issues before outsiders are permitted to do so.

INFLUENCE OF CAPITAL-MARKET CONDITIONS

Convertible issues also invite particular attention when they can be used to take advantage of capital-market conditions. Such has been the case throughout much of the past decade because the conversion feature provided a tempting lure of protection against the contingencies of inflation. In 1960, some 94 convertible bond issues in the amount of $347,216,700 were offered to the public; the respective figures for 1959 were 79 and $514,942,800. The conversion feature also appeared in 19 preferred stock offerings for $35,446,911 in 1960 and, in 1959, the comparable figures were 32 and $230,557,165.[15] As noted in our discussion of small-business financing (see pages 331–32), the exercise of the conversion privilege also serves to strengthen the net-worth or equity base and thereby bolster the corporate position for later borrowing.

THE VALUE OF A RIGHT TO SUBSCRIBE TO CONVERTIBLE ISSUES

To determine the value of a right to subscribe to a new convertible bond or preferred stock, the same general principles which underlie stock rights may be applied. To single out the minor differences, attention may be called, first, to the fact that the value of the new issue would necessarily be determined on a "when-issued" basis, whereas common stock would already have a known market value. Second, the issuance of a convertible bond or preferred stock means that there is no immediate addition to the number of shares of outstanding common stock, thereby avoiding immediate dilution of its value. Instead, conversion usually results in rather immeasurable, but continuous, dilution in keeping with the rate at which the bonds or preferred stock are converted into common stock. Because no new stock is issued at the time of offering convertible securities, the formula for computing the nominal value of the right would be as follows:

$$\frac{\text{Market Value of New Issue less Offering Price}}{\text{Ratio of Shares to New Issue}} = \text{Nominal Value of Right}$$

The formula may be tested by applying it to the specific case of the convertible subordinated debenture 4½'s, due in 1981, of the Brunswick Corporation. Stockholders of record on January 11, 1961, were given the right to subscribe for $100.00 face value of bonds (the rights expiring on

[15] *Investment Dealers' Digest,* February 6, 1961, sec. 2, p. 22.

January 25, 1961) for each 65 shares of stock held; in effect, the difference between the market price of the bond and the subscription price would be divided among 65 shares of stock. Taking a random date, January 13, 1961, we may note that the market price of the bonds on a "when-issued" basis was 124; accordingly the nominal value of the right would be determined as follows:

$$\frac{\text{Bond Price (124) less Offering Price (100)}}{\text{Ratio of Shares to Bonds (65)}} = \frac{24}{65} = \$0.369$$

On the same day, the rights had an actual price range of $\frac{3}{8}$ (0.375) to $\frac{23}{64}$ (0.359), or approximately at their nominal value. For the entire "rights period," the market price of the rights ranged from a low of $\frac{18}{64}$ to a high of $\frac{29}{64}$, while the bonds had a range of $119\frac{1}{8}$ to $128\frac{3}{4}$.

Because the formula is applied in the same manner in computing the value of a right to subscribe for preferred stock, there is little need to develop its arithmetical calculation. However, for the sake of example, brief reference may be made to the use of such rights in actual practice. In the case of the Crucible Steel Company of America, the rights were issued to common stockholders of record, May 26, 1959, to purchase 99,985 shares of cumulative convertible $5\frac{1}{4}$ per cent preferred stock at $100.00 per share on the basis of 1 share of preferred for each 38 shares of common. The terms of conversion provide that the preferred stock may be exchanged for common at a price of $29.00 so long as the former remains outstanding. However, the corporation reserved the right to redeem the preferred stock at a price of $105.25 to May 31, 1964; then at $103.00 to May 31, 1969; then at $101.00 to May 31, 1974; and thereafter at $100.00 per share. Stockholders subscribed for 96.87 per cent of the offering, and the remaining 1,917 shares were sold to the public by the underwriting group. It may be noted that the purpose of the funds realized by this issue was to pay part of the cost of plant improvements.

Indicative of the influence of special circumstances relating to financial procedures is the $2.25 series B cumulative, convertible, second preferred stock of the Flintkote Company which was issued in the latter part of 1960. Unlike the preceding example, there was no underwriting, and the stock had voting rights—one-half vote per share of stock. The purpose of the issue was to effect a merger or acquisition of the assets of two other companies; consequently, there was no need for underwriting since failure to accomplish the merger would eliminate the need for the stock. In turn, the voting privilege was a natural feature because the common stock to be acquired necessarily had such rights. The new second preferred stock is convertible into common stock at $45.00 per share ($1\frac{1}{9}$ shares of common for each share of preferred) as long as the former remains outstanding; however, beginning with July 1, 1965, the stock is callable at a price of $52.50 plus any accrued dividends.

OBLIGATIONS WITH WARRANTS

When rights to buy either stock or convertible securities are used, there is need to exercise the option within a comparatively short period of time. With conversion issues, the transition to stock may be deferred to a much later date, but, even here, the initial outlay constitutes a major investment by the investor. Under another method, the privilege of buying stock may exist over a number of years without, at the same time, necessitating an immediate commitment of funds for the entire investment potential. Reference is made to warrants which authorize the purchase of common stock in the future at predetermined prices. While warrants are usually included as a feature of new offerings of preferred stock and bonds (generally of the debenture type), they may also be used by new companies when selling common stock.

In earlier years, warrants had a more or less "fringe" status with respect to their recognition by the financial community; in other words, they were not accorded the dignity or prestige commonly associated with rights offerings of the type discussed previously in this chapter. But the atmosphere of the fifties changed "financial mores" in many ways, and, as a result, warrants have gained fairly wide acceptance—especially when they may be needed for "sweetening" purposes. Indicative of the change in thinking is the recent volume of offerings which featured warrants. In 1960, 49 bond offerings amounting to $205,248,637 had either warrants or stock which was part of unit offerings to the public; the respective figures for 1959 were 41 and $225,147,250.[16]

The wider use of warrants and stock options was likely stimulated by the desire of investors to hedge their bond purchases against the contingencies of inflation; and, probably of equal import, has been the practice of treating realized profits as a capital gain for income tax purposes rather than ordinary income. Under these conditions, warrants often lured the so-called "sophisticated" investor who previously ignored them because of their speculative nature. As of this writing, there are indications that the government may not allow gains on warrants to be treated as a capital item; and, if this materializes, the popularity of warrants could be vitally affected.

The holder of a warrant has the delightful alternative of not investing if the conditions are not attractive, or of investing in the stock if dividend returns or capital appreciation appears to be favorable. Under the circumstances, the following restrictions or conditions are usually incorporated in the terms relating to the warrant privilege: (1) The terms of purchase of stock are made less favorable the longer the exercise of the option is delayed; (2) there is usually a time limit which causes the option to expire; and (3) adjustment of the terms following stock dividends,

[16] *Investment Dealers' Digest, op. cit.*, p. 22.

splits, etc. is customarily provided. The following examples of securities carrying purchase warrants illustrate many of these features:

Sperry Rand Corporation. Warrants were issued with the debenture 5½'s, due in 1982. These bonds were sold in 1957 in the amount of $110,000,000, and the warrants could not be exercised or detached until March 17, 1958. Beginning at that time, the holder of each $1,000 bond had the right to buy common stock at $25 per share until September 16, 1963; from that date to September 15, 1967, the purchase of stock may be made at $28 per share, after which the warrants expire. The stock had a price range of 18⅜ to 26¼ in 1960; the respective figures for the warrants were 7⅛ to 11¾.

The Martin Company. In 1958, warrants were issued with a new offering of $20,000,000 debentures 5½'s, due in 1968. Each $1,000 bond had ten warrant rights to 10.5 shares of common stock at a price of $40 per share to November 1, 1963, and then at a price of $45 per share until the expiration date of November 1, 1968. In 1960, the stock ranged from a low of 36 to a high of 65⅜; the price of warrants ranged from 17⅜ to 33⅞.

Fedders Corporation. The warrants in this case were issued in connection with the sale in 1959 of $3,812,300 subordinated debenture 5½'s, due in 1979. For each $100 of debentures, attached warrants authorize the purchase of 4 shares of common stock at a price of $15.875 per share from September 30, 1959 to the expiration date of May 31, 1962. In this instance, new bonds are issued upon exercise of the warrants. On an ex-warrant basis, the bonds ranged in price in 1959 from 75 to 84½, while bonds with warrants sold from a low of 99 to a high of 109½; the price range of the stock was 16½ to 22⅛. Currently (March 30, 1961) the stock is selling at 23¾.

Dynacolor Corporation. In this case, the warrants were issued only to the underwriting firm (Lee Higginson Corporation) and authorized the purchase of 25,000 shares of common stock at a price of $8.75 per share at any time from May 1, 1960 to May 1, 1964. This option was part of the consideration for handling the sale in 1959 of securities of the corporation. Specifically, the public was offered units of $100 subordinated debenture 5½'s, due in 1979, and 5 shares of common stock at a price of $130 per unit; in addition, there was a separate offering of 75,000 shares of common stock to the public at a price of $8.75 per share. The stock had a price range of 8¾ to 42¼ in 1959.

Van Norman Company. In 1955, units consisting of 1 share of common stock and 1 warrant were sold at a price of $14. The offering was made to the old stockholders on the basis of 1 unit for every 3 shares of old stock. The warrants permit the purchase of additional stock at a price of $16.50 per share at any time for a period of 10 years. The stock had a price range of 4⅝ to 17⅜ from 1954 to 1960; currently (March 30, 1961) the stock is selling at 11⅞.

As indicated by the foregoing illustrations, detached warrants may be bought and sold in the market as instruments in their own right. Needless to say, they may sell above or below their mathematical value (difference between market and option price of the stock) depending upon the market outlook for the prospects of the particular company's operations. If the warrants do not have the detachable privilege, they may be exercised by returning the bonds to the company along with sufficient funds to purchase the stock; a new bond without the warrant is then issued along with the stock. Market prices will then reflect the absence or presence of the warrant; for example, in 1960, the convertible subordinated debenture

5.90's, due in 1971, of Chadbourne Gotham, Inc. had a price range of 116 to 73⅜ with warrants; without warrants, the price ranged from 100 to 73.

From the point of view of general financial policy, the use of warrants has its pros and cons. An attractive option does expedite the sale of the original issue; but, at the same time, it may interfere with later financial planning. Funds received as a result of the exercise of the option may or may not coincide with the corporation's need for funds, although it may be said that any surplus cash could be used to call bonds or preferred stock. Even so, the financing is more of the forced variety than it is of the normal and controllable direction of corporate affairs. It is also questionable whether the use of warrants adds to the prestige of the corporation's financial standing; rather it reflects the need for some special inducement in order to attract public response.

THE QUESTION OF UNDERWRITING

Offerings to existing stockholders pose a number of questions relating to the desirability of underwriting such issues. In our consideration of the problem we shall direct our main attention to the sale of additional stock to stockholders of record. Here there is an established potential market, and it would be easy to conclude that there is minimum need for the assurance provided by underwriting. Also, there may be resort to the practice of allowing stockholders to subscribe for more than their primary rights as a possible offset against the inaction of nonsubscribers; in the event of oversubscription, the dilemma is easily resolved by meeting the primary subscriptions in full and handling the balance on a pro-rata basis. However, it is common practice to utilize the services of investment bankers in some capacity as a means of expediting the sale of the securities, and often the arrangement is for complete underwriting.

From the management or corporate point of view, it is only natural to want certainty of result; otherwise, there may be undue interference with the flow of financial planning. And there are contingencies even in the disposal of securities of recognized standing. The securities market has many moods, and any corporation with a new security offering can be embarrassed by adverse developments. Particularly, quick changes may take place in the stock market.

The dangers of market fluctuation were especially dramatized in the crash of the stock market in the fall of 1929. At that time, for example, the Cities Service Company found it necessary to recall rights, even after they had been traded in the market. In another case, the North American Company declared rights in favor of stockholders of record as of October 17, 1929, permitting new subscriptions at a price of 100. On October 8, 1929, its stock was selling around 160. Before the termination of the rights privilege, the stock had sold as low as 77. Such embarrassment was experienced by a number of corporations.

Under favorable conditions, the underwriters may be called upon to sell only a small amount of securities, if any at all. In the sale of 32,842 shares of common stock of the Black Hills Power and Light Company at $28.50 per share in July, 1960, no stock was acquired by the underwriters (Dillon, Read & Co., Inc.). The exercise of the primary rights accounted for 29,955 shares, and the oversubscriptions were 13,798 shares.[17] The underwriter received a gross fee of ¾, from which soliciting dealers were paid ¼ for obtaining subscriptions.

Under other circumstances, the underwriters may be forced to take up a large portion of the new issue. A case in point is the $48,000,000 issue of convertible debentures offered by Bethlehem Steel Corporation to its stockholders in September, 1937. The offering carried a 3½ per cent rate, and subscriptions were to be at par on the basis of $15 in debentures for each share of stock held. Owing to the conditions prevailing in the securities markets at the time, the issue was poorly received; and the underwriters were forced to take up more than $46,000,000 of the debentures.

There are few cases in which investment bankers have ever failed to meet the obligations of their underwriting guaranty. However, this turn of affairs did occur in 1948 when Otis & Company, an investment firm in Cleveland, Ohio, refused to take over the stock of the Kaiser-Frazer Corporation which it had underwritten for slightly more than $10,000,000. The market price of the stock broke below the offering price, and the banking firm was faced with the prospect of taking almost the entire issue. At or about this time, a stockholder's suit was filed against the Kaiser-Frazer Corporation; and the investment company charged that it affected the basis of the underwriting. The corporation then brought suit against Otis & Company alleging a breach of contract and in July, 1951, was awarded damages of about $3,100,000. However, upon appeal, the decision was reversed on the grounds that the prospectus contained a statement that did not show the true earnings for the last quarter of the year preceding the offering. It was further held that the prospectus "formed an integral part of the contract between corporation and underwriter for purchase of stock" and that "even though underwriter had full knowledge of facts before entering into contract," the contract was contrary to public policy and in violation of the requirements of the Securities Act of 1933.[18]

As noted in Chapter 18, arrangements may be made to have the investment banking firm serve simply as a "dealer-manager" of an offering without underwriting the issue. Or, there may be an agreement whereby the securities are offered on a "best-efforts" basis; under these conditions, the sales program is likely to be extended over a period of time. But, whatever the plan, the price paid is intended to be a *quid pro quo*, constituting a payment for services rendered in handling various details of

[17] *Investment Dealers' Digest, op. cit.*, p. 72.

[18] *Kaiser-Frazer Corp.* v. *Otis & Co.*, 195 F. 2d 838.

the sale of securities and, in the case of underwriting, a premium for the risk assumed.

EVALUATION OF OFFERINGS TO EXISTING SECURITY HOLDERS

In its broadest sense, the sale of new issues to existing security holders would include offerings to bondholders as well as to stockholders; but for all practical purposes, only the latter are involved. Bondholders may be given a prior right of subscription in connection with the call and refunding of existing bonds; but the extension of this preference is strictly optional on the part of the corporation, and the practice is not common. Of the $10,538,657,000 of corporate securities of all types registered under the Securities Act of 1933 and proposed for cash sale in the fiscal year ended June 30, 1960, some $772,803,000 were offered to existing security holders, or about 7.3 per cent of the total. For the fiscal year ended June 30, 1955, the comparable figures were $1,512,441,000 and 19 per cent, respectively.

There are indications that management may be giving more consideration to the expediencies of financing than to the accommodation of existing stockholders, and the inconveniences of the latter are readily apparent. However, the relative importance of offerings to the old stockholders cannot be measured only in terms of amount; in addition, we should recognize the significance of strong ownership by the general public. Social trends are such that public following and good public relations are vital requisites of a sound corporate position. Management may be caught on the horns of a dilemma; on the one hand, it may wish to avoid the inconvenience of contacting a widely scattered group of stockholders but, on the other hand, it realizes there is danger in pursuing a policy of corporate isolation. In turn, it is recognized that corporate loyalties spring more from ownership by common stockholders than from the investment motives of bondholders.

QUESTIONS AND PROBLEMS

1. Discuss the statement that "management seems to be emerging into a distinct entity in its own separate and distinct capacity."
2. Do you favor statutory provisions permitting the limitation or denial of pre-emptive rights?
3. "Aside from the pre-emptive right of stockholders to subscribe for new stock, such preference in favor of existing stockholders should aid in the building of corporate family ties." Do you think that "corporate family ties" are feasible in large corporations? In small corporations?
4. What is your opinion of the policy reflected in the case of Montgomery Ward & Company, as discussed on page 364.
5. What factors should be considered in determining the spread between the market price of the old stock and the subscription price of the new stock?
6. Select one or two cases of stocks sold by rights' offerings and study the following: (*a*) effect of the transaction upon the book value of the stock;

(*b*) effect of the transaction upon the market value of the stock; and (*c*) other pertinent details concerning the nature and success of the offering.

7. Discuss the merits of the financial policy of the American Telephone and Telegraph Company in raising such a large amount of capital from its existing stockholders.
8. Analyze the possible dilution resulting from the issuance of rights, of (*a*) market value and (*b*) book value.
9. Discuss the policy and legal aspects of selling convertible bonds by the use of rights, and comment on the nature of dilution of stock values which results from conversion.
10. Discuss the merits of using warrants as a means of attracting capital for (*a*) established companies and (*b*) newly formed corporations.
11. Do you think that any profit realized by the exercise of warrants and sale of the stock should be classified as a capital gain or ordinary income?
12. Discuss the meaning and significance of the observation that "the atmosphere of the fifties changed the 'financial mores' in many ways."
13. Discuss the advantages and disadvantages of selling new securities to existing stockholders without underwriting.
14. Discuss the risks of underwriting stock issues as compared with bond issues.
15. Evaluate the merits of allowing and encouraging subscriptions in excess of those arising out of primary rights.
16. Comment on the following statements made in an article entitled "Spot vs. Rights Offerings" (*Investment Dealers' Digest*, February 24, 1958, p. 15): (*a*) "There are many reasons why stockholders should have pre-emptive rights, but most of them are purely theoretical." (*b*) "Indeed, rights themselves are an annoyance to the small stockholder." (*c*) "The do-gooders of the SEC used to make much of it, but like the efforts of so many do-gooders, this factor has no practical importance. It is just plain silly."

REFERENCES

BOGEN, J. I. (ed.). "Corporate Stock," *Financial Handbook*, pp. 444–53. New York: The Ronald Press Co., 1957.

COBLEIGH, IRA U. "Warrants in Arrested Markets," *Commercial and Financial Chronicle*, Vol. 187, No. 5712 (January 30, 1958), p. 4.

DOLLEY, J. C. "The Price Effect of Stock Right Issues," *Journal of Business*, Vol. VIII (April, 1934), pp. 133–60.

DONALDSON, ELVIN F. *Corporation Finance*, chaps. xii, xvii. New York: The Ronald Press Co., 1957.

EVANS, GEORGE HEBERTON, JR. "The Theoretical Value of a Stock Right," *Journal of Finance*, Vol. X, No. 1 (March, 1955), pp. 55–61.

GUTHMANN, HARRY G., and DOUGALL, HERBERT E. *Corporate Financial Policy*, chap. xvii. Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1955.

JOHNSON, ROBERT W. *Financial Management*, chap. xv. Boston, Mass.: Allyn and Bacon, Inc., 1959.

PRATHER, CHARLES L. *Financing Business Firms*, chap. 18. Rev. ed. Homewood, Illinois: Richard D. Irwin, Inc., 1961.

Stevens on Corporations, sec. 3. St. Paul: West Publishing Co., 1936.

WILLIAMS, CHARLES M. and HOWARD A. "Incentive Financing—A New Opportunity," *Harvard Business Review*, Vol. XXXVIII, No. 2 (March–April, 1960), pp. 123–24.

Chapter 20 ►

REGULATION OF THE SALE OF NEW SECURITY OFFERINGS

DURING THE last three decades or so, we have witnessed a marked change in the nature of our general economy. Prior to the thirties, the *modus operandi* was mainly one of free, private enterprise; today, the activities of government extend into almost every conceivable area of business operation. The role of government embraces both direct participation in our economic life and regulation of various fields of private endeavor. It is not our purpose to debate the merits of the resulting issues; but, if we are to appreciate the practicalities of modern corporation finance, we need to understand the legislation pertaining to corporate securities and related matters. Also, it should be observed that the desirability of regulating the sale of security issues was recognized by the individual states long before the federal government entered the field.

EXTENT AND PURPOSE OF STATE LAWS

Legislation relating to the sale of securities was first enacted by Kansas in 1911; and, by 1923, all of the states except Delaware and Nevada had adopted such legislation. In 1931, Delaware enacted such a law, leaving Nevada the only state without some regulation of the sale of securities at the present time. Known generally as "blue-sky" laws,[1] they were quickly attacked as to their constitutionality; and several state and lower federal courts held a series of such statutes unconstitutional. However, all questions as to their constitutionality under the federal Constitution were put at rest by the Supreme Court of the United States when that court, in three decisions handed down in 1917, held such laws to be a constitutional

[1] "The name given to the law indicates the evil at which it is aimed, that is, to use the language of a cited case, '*speculative schemes which have no more basis than so many feet of blue sky*'; or, as stated by counsel in another case, 'to stop the sale of stock in fly-by-night concerns, visionary oil wells, distant gold mines, and other like fraudulent exploitations.'" (Italics added.) *Hall* v. *Geiger-Jones Co.,* 242 U.S. 539, 550 (1917).

exercise of the state's police power to legislate for the general welfare of the people in the prevention of frauds.[2]

Although the underlying purpose of the blue-sky laws of the various states is to protect the investing public in one way or another, they differ widely both in scope and in detail. In some states, the statute is designed mainly to prevent fraud, leaving it to the individual purchaser, unhampered by fraud or misrepresentation, to determine the wisdom of his purchase. In other states, the statute is designed not only to prevent fraud in the sale of securities by requiring a full disclosure of all pertinent facts and establishing penalties for misrepresentation and deceit but also to prevent the sale of securities that have been found to be unsound or of low quality according to standards specified in the statute or the sale of securities on terms not considered fair.

NATURE OF REQUIREMENTS

When we consider the varying purposes or objectives of the various state laws, it is not surprising to find marked differences in their requirements relating to new security issues. When the purpose is confined primarily to the prevention of fraud, there are no requirements that the *securities* be registered or qualified. However, there may be provision for the licensing or registration of security *dealers*. For example, in three states,[3] it is provided that no person shall engage in business in the state as a dealer in securities without being licensed to do so. Authority to refuse a license and to revoke for cause a license once issued is vested in some state official or in a regulatory body such as a securities commission. In another state,[4] dealers do not have to meet any requirements but must register or file with the proper state official.

Protection of investors under the foregoing circumstances rests mainly upon criminal penalties for fraudulent action. The attorney general or some other official is given authority to investigate and, in his discretion, to institute court proceedings to restrain the distribution of issues that are believed to be fraudulent. Under statutes of this type, it is expected that criminal penalties will serve to deter dishonest practices and that investors should be expected to evaluate the factors of risk and the investment potential.

The most common type of blue-sky law provides for both the registration of dealers in securities and the qualification or registration of the securities to be sold.

Registration of Dealers. The details of registration of dealers vary from state to state but, for the sake of example, we may note the key re-

[2] *Ibid.; Caldwell* v. *Sioux Falls Stock Yards Co.*, 242 U.S. 559 (1917); *Merrick* v. *N. W. Halsey & Co.*, 242 U.S. 568 (1917).

[3] Connecticut, Maine, and Pennsylvania.

[4] Maryland.

quirements set forth in the Alabama statute. Among other things the applicant must set forth his "proposed method of doing business," "qualification and business history," and his "financial condition and history." Unless the applicant has a net worth in excess of $25,000, a fidelity bond payable to the state of not less than $10,000 must be furnished. If the state commissioner does not issue a "denial order," the registration becomes effective in thirty days unless specifically approved for an earlier date.[5]

The law naturally prohibits all fraudulent practices "in connection with the offer, sale or purchase of any security, directly or indirectly." Both untrue statements and the omission of material facts also become grounds for liability by dealers. Salesmen who are employed by dealers must also qualify for registration.

Registration or Qualification of Securities. Securities must be registered with the proper state authority unless they are exempted because of compliance with legislative stipulations. In Alabama, the requirements of registration may be met by one of the following three methods or procedures: (1) notification, (2) co-ordination, or (3) qualification.[6]

Notification. If the securities meet standards prescribed by statute, registration is effected simply by notifying the state commissioner. Among the tests of security performance, we may note only the following two: (a) the issuer must "have been in continuous operation for at least five years," and (b) the record must show no default during the current and three preceding fiscal years "in the payment of principal, interest, or dividends on any security . . . with a fixed maturity or a fixed interest or dividend provision." A registration statement, somewhat comparable to the federal form described later in this chapter (see p. 391), must also be filed for purposes of public record.

Co-ordination. If the securities have already been registered with the federal authorities under the Securities Act of 1933, the state registration requirement is basically met by filing three copies of the prospectus cleared by the Securities and Exchange Commission and proof that the federal registration statement has become effective. The term "co-ordination" denotes its underlying purpose, viz., recognition of approvals given by the Securities and Exchange Commission (in the state of Illinois, the term "description" is used to connote the same procedure.)

Qualification. Securities that do not fall within either of the previous two categories may be cleared for sale or trading by express approval of the state securities commissioner. Again, a registration statement setting forth detailed information must be filed. Among other things, this statement must disclose pertinent facts relating to such features as: the general character of the business of the issuer; the reputation and record of the officers, directors, and every promoter as well as any amounts paid to such persons; the capital structure, either actual or *pro forma;* the kind and amount of securities to be offered; the purposes for which the proceeds are to be used; any stock options outstanding or to be created; and other miscellaneous items that may have a bearing on the security offering.

There are indications that the individual states are increasingly using the federal laws as a pattern for their own statutory enactments. By this

[5] Code of Alabama, Title 53, sec. 29.

[6] *Ibid.,* secs. 31–33.

means, unnecessary duplication is avoided and greater standardization of procedures is facilitated. However, there may be a basic distinction in the motivation or purpose of federal and state laws. The former serve mainly to assure a full disclosure of all material facts (see pp. 385–87); the latter not only fulfill this function but, in addition, may permit the appropriate authorities to pass judgment upon the risk features of security offerings.

EXEMPTIONS OF STATE LAWS

State laws ordinarily contain generous exemptions both of securities and of transactions. The securities exempted are usually those whose safety or character is thought to be assured by the nature of the business of the issuer, by public regulation of the issuer, or by some other assuring factor. They ordinarily include, in part, the following: securities issued or guaranteed by the United States government, by any state or any political subdivision of a state, or by any foreign government; issues of banks or corporations supervised or controlled by the state or United States government; issues of public-utility corporations supervised by the state or federal government; securities of educational and eleemosynary institutions; securities listed and dealt in on the New York Stock Exchange or other approved stock exchanges; and certain types of local securities about which there is presumed to be sufficient knowledge.

Transactions that provide a basis for the exemption of the securities affected usually include, among others, judicial sales, distribution of stock dividends to stockholders, and sales to those who are presumed to have enough knowledge to safeguard themselves, such as licensed dealers and banks.[7]

WEAKNESSES OF STATE LAWS

Unfortunately, legislative action by the individual states has proved exceedingly inadequate to protect the investing public against the abuses and frauds arising in the issuance and sale of new securities. The huge amount of estimated losses during the decade prior to 1933 in worthless securities[8] was seemingly little reduced by the existence of blue-sky laws in practically every state in the Union. Various legal devices made successful evasion of state blue-sky laws relatively easy,[9] and the complex

[7] For a good discussion of the usual content of state blue-sky laws and the general nature of their provision, see the . . . Note on "Blue-Sky Legislation," *Iowa Law Review*, Vol. XXIII (1936), p. 102.

[8] The total has been estimated at $25,000,000,000. See the *New York Times*, May 28, 1933, p. 2, for the statement of President Roosevelt on signing the Securities Act.

[9] The most common method is the consummation of a sale across state lines, with the transaction so arranged that the last act prerequisite to the effectiveness of the sale occurs in a state having either a lax blue-sky law or one inapplicable to the particular transaction. Legal doctrine makes the contract of sale involved in such a transaction a contract of the seller state and not subject to the law of the buyer state.

interstate character of most corporate financing meant that the blue-sky promoter could obtain almost complete immunity by the mere transfer of his operations to interstate commerce where both practical and constitutional limitations prevented effective state action.[10]

THE BEGINNINGS OF A FEDERAL PROGRAM

Under the Mail Fraud Act[11] passed by Congress in 1909, there had been a form of federal regulation of sales of fraudulent securities through the use of the mails; but this legislation needed to be supplemented.[12] A much more comprehensive federal program was obviously essential in order to secure effective regulation of new security sales. Ultimately, the catastrophic break in the stock market in 1929 and the ensuing business depression served to mobilize public opinion in favor of a federal program.

In the political campaign of 1932 and thereafter, President Roosevelt constantly emphasized the need of protecting the small investor. Looking beyond the historic policy of *caveat emptor*, he advocated a doctrine of "let the seller also beware." He maintained the position that the financing process was largely of a fiduciary character. "What we seek is a return to a clear understanding of the ancient truth that those who manage banks, corporations, and other agencies handling and using other people's money are trustees acting for others." Under this principle, those engaged in the process of financing corporations should be held strictly accountable for their "wares." This basic policy finally took shape in the following legislative measures: (1) the Securities Act of 1933; (2) the Securities Exchange Act of 1934.[13]

The first of these laws is designed primarily to regulate public offerings of new securities,[14] and a discussion of its main provisions will con-

---

[10] See *Hearings*, H.R. 4314, 73d Cong., 1st sess., pp. 10, 99; *Hearings*, S. 875, 73d Cong., 1st sess., pp. 214–15.

[11] 35 Stat. 1130 (1909).

[12] The postal administration has been commended for its efficiency in preventing, under the power given it by the act, the sale of worthless securities. See, for example, Forrest B. Ashby, "Federal Regulation of Securities Sales," *Illinois Law Review*, Vol. XXII (1928), pp. 635, 637–38. However, the difficulties, due in large part to the restrictive nature of the statutory power, resulted in a definite inability to cope with the problem.

[13] Numerous amendments to the Securities Act of 1933 were made by the Securities Exchange Act of 1934, principally in the exemption provisions and the civil liability provisions. The discussion of the Securities Act in this chapter is of the Securities Act as it exists on the statute books today. For detailed comments on the amendments made by the Securities Exchange Act of 1934, see L. K. James, "Amendments to the Securities Act of 1933," *Michigan Law Review*, Vol. XXXII (1934), p. 1130.

[14] Section 17 of the Securities Act also makes unlawful the use of mails or any instrumentalities of transportation or communication in interstate commerce to defraud buyers of securities *whether newly issued or not.*

stitute the balance of this chapter. The Securities Exchange Act is concerned mainly with the regulation of the national stock exchanges and the listing of securities and is treated in the succeeding chapter.

STATE LAWS STILL APPLICABLE

At the outset, it should be made clear that enactment of the federal Securities Act did not supplant state regulation of the sale of securities. Section 18 of the act provides: "Nothing in this sub-chapter shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person." The court in *Securities and Exchange Commission* v. *Timetrust, Inc.*,[15] said that this section did not indicate an intention on the part of Congress to limit the Securities Act to activities in interstate commerce but, at most, merely gave concurrent jurisdiction in such cases to the Securities and Exchange Commission and state authorities.[16] Furthermore, apart from any possible constitutional restriction on the extent to which the federal government can regulate intrastate transactions in securities, there is still an area reserved exclusively for state regulation by the terms of the statute itself. Section 3 (*a*) (11) provides that the act shall not apply to "any security which is a part of an issue sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory."

BASIC PURPOSE OF THE SECURITIES ACT

Intelligent consideration of particular provisions of the Securities Act requires an initial survey of its fundamental purpose. The clear objective of the act is to assure adequate publicity and disclosure of facts that will enable potential investors to form an intelligent judgment of the worth of newly issued securities. To this end, the act prohibits the use of the mails or of any means or instruments of transportation or communication in interstate commerce to offer, sell, or deliver after sale any security,[17]

[15] 28 F. Supp. 34 (1939).

[16] See R. S. Smith, "State 'Blue-Sky' Laws and the Federal Securities Acts," *Michigan Law Review*, Vol. XXXIV (1936), p. 1135, for a discussion of state blue-sky laws with reference to the extent of their application to interstate transactions, their constitutional validity as applied to such transactions, areas of concurrent regulation under state laws and the federal Securities Act, and the desirability of amending state laws to take cognizance of the situation created by the enactment of the Securities Act.

[17] Section 2 (1) of the Securities Act of 1933 defines "security" as follows: "The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, reorganization certificate or subscription, transferable

with certain exceptions, unless (1) the issuer files a registration statement with the Securities and Exchange Commission containing certain prescribed information about the security issue; and (2) distribution of the security to investors is accompanied or preceded by a prospectus containing in condensed form most of the information given upon registration. Also, irrespective of whether the security concerned must be registered under the act, there is a prohibition against the use of the mails or any means of interstate commerce for the sale of securities through false or misleading communications or by fraudulent methods.[18] A seller who violates either of these two prohibitions is subject to both civil liabilities (purchaser may sue for damages or, in certain cases, rescind his purchase and recover the consideration paid) and to criminal penalties if the violation is willful.

Administration of the act is in the hands of the Securities and Exchange Commission. The Securities Act, as orginally passed, entrusted the administration of the act to the Federal Trade Commission. Later, the Securities Exchange Act, passed in 1934, transferred administration of the act to the more specialized Securities and Exchange Commission.

It must be understood that the Securities Act does not in any way guarantee either the quality of the security or the soundness of the business of the issuer. The absence of requirements covering the merits of new security issues has been emphasized by both the President[19] and Congress.[20] The registration statement simply places certain prescribed facts about the security on record, and the prospectus conveys these facts to potential investors in convenient form. Neither guarantees the quality of the security about which the facts are given nor states any conclusion as to the merits of the security. To show plainly the absence of certification as to merit, the Commission requires that "on the outside front cover page of every prospectus," there must be stated in conspicuous print the following statement:

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE. (Rule 425, General Rules and Regulations under the Securities Act of 1933.)

---

share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or puchase, any of the foregoing.

[18] The act thus extends to all securities transactions in interstate commerce the protection formerly afforded by the Mail Fraud Act only when the mails were employed.

[19] See *Hearings*, H.R. 4314, 73d Cong., 1st sess., p. 1.

[20] See *Hearings*, S. 875, 73d Cong., 1st sess., pp. 103–5.

Under the act, the Commission must register any security issued where the registration statement is not on its face incomplete or inaccurate. The highly speculative character of the business enterprise in which the issuer is engaged is no ground for refusing use of the mails or the channels of interstate commerce.[21]

As a matter of policy, the investor should and under the act will continue to carry the business risks inherent in the commitment of capital; and losses (without recovery) should still remain as a more or less normal feature of investment. That portion of risk arising from lack of information or from misrepresentation should tend to be eliminated. This is the primary purpose of the act, and it is not surprising that it has been referred to as the "Truth in Securities Act."

PROVISIONS OF THE ACT

In the following discussion of the provisions of the act, consideration will be given to the following topics: (1) securities and transactions exempted from the application of the act; (2) registration requirements; (3) prospectus requirements; and (4) civil and criminal liabilities arising from false registration statements and prospectuses and from false and misleading communications.

Certain securities and transactions are exempted from the registration requirement and the consequent duty of sending a prospectus. The exemption afforded does not, however, extend either to the criminal provisions of the act or to the prohibitions of the act against fraudulent interstate transactions. Thus, even though a security is exempt, the seller is still liable for fraud or misrepresentation whenever there is use of the mails or any means of interstate commerce; and the purchaser may rescind the purchase and recover the consideration paid, or he may sue for damages.

SECURITIES EXEMPTED

In presenting the most important classes of securities which are exempted from registration, it is convenient to classify them according to the reasons that serve as a basis for their exclusion. The first group consists of issues that are already subject to government influence, either as

---

[21] See *Hearings,* H.R. 4314, 73d Cong., 1st sess., p. 58:

MR. THOMPSON. . . . I think that is a thing we must not stop, speculative investments.

MR. PETTENGILL. In other words, if a man wants to invest money in a proposition to make gold out of sea water, we do not want to stop it.

MR. THOMPSON. I should think that is true.

MR. PETTENGILL. As long as he knows what he is putting his money into and wants to take the risk.

MR. THOMPSON. Yes.

a result of direct issuance by a governmental body itself or as a result of existing supervision or regulation. In this category will be found the following:

1. Government securities, including securities issued or guaranteed by the federal or state governments, or by their instrumentalities or political subdivisions.
2. Securities issued by common carriers, the issuance of which is subject to the regulation and control of the Interstate Commerce Commission.
3. Securities of national banks, state banking institutions which are under state supervision, and savings and loan associations (meeting certain specified requirements).

The second basis for the exemption of securities arises more especially out of the nature of the transaction. For instance, instruments used in the financing of current operations do not normally find an outlet in the investment market but are usually handled by specialized financial institutions with adequate facilities of their own to obtain the necessary supporting information. Securities used in transactions that do not materially affect the *status quo* may be excluded by virtue of this restricted influence. The following types of exemption are illustrative of these principles:

1. Drafts and other documents arising out of current transactions when the maturity does not exceed nine months.
2. Securities exchanged for outstanding securities when no commission or other remuneration is paid for soliciting the exchange. Similarly, broad exemptions are extended to securities issued as a result of reorganization.

Securities are also exempted when the burden on the issuer is obviously disproportionate to the benefit to the public. On this basis, the size of the issue and the nature of the activities of the issuing body are the chief determining factors for exemption and are illustrated by the following:

1. Securities issued by nonprofit organizations which are operated for religious, educational, benevolent, fraternal, or charitable purposes.
2. Securities exempted because of size of issue by the Securities and Exchange Commission. The Securities Act empowers the Commission to exempt securities from registration when it finds that registration is not necessary "in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering." This power of the Commission is limited to offerings not in excess of $300,000.[22]

[22] The regulations promulgated by the Commission fall into two classes: (1) regulations relating to securities designated as "fractional undivided interests in oil or gas rights" and (2) regulations relating to other securities. Originally, the exemption was limited to $100,000; but the amount was increased to $300,000 in 1945. See U.S. Code, Annotated, Title 15, sec. 77 *c*(*b*), p. 434.

OFFERINGS OF $300,000 AND LESS

While the Securities and Exchange Commission has exercised its authority to exempt offerings of $300,000 and less from the filing of a registration statement, they are still subject to other specified requirements. First, notification of a proposed offering must be made to the Commission on a prescribed form and, unless earlier approval is given, the initial offering of the securities must be deferred for 10 days (exclusive of Saturdays, Sundays and holidays). Second, unless the offering is $50,000 or less, "no securities shall be sold . . . unless an offering circular . . ." is given or sent to the person to whom the securities are sold.

Although the term "offering circular" is probably self-explanatory, it may be noted that it is a limited or condensed form of prospectus. The latter as defined by the act (sec. 2[10]) "means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security . . . ," but exceptions are provided for communications used after the effective date of the registration statement and for other reasons of a similar nature. The Commission's rules and regulations spell out the minimum items of information that must appear in the offering circular, and include: details about the issuer, kind and amount of securities to be offered, aggregate underwriting discounts or commissions to be paid, and appropriate financial statements. In addition, the following statement must appear in capital letters on the front page of the circular:

THESE SECURITIES ARE OFFERED PURSUANT TO AN EXEMPTION FROM REGISTRATION WITH THE SECURITIES AND EXCHANGE COMMISSION. THE COMMISSION DOES NOT PASS UPON THE MERITS OF ANY SECURITIES NOR DOES IT PASS UPON THE ACCURACY OR COMPLETENESS OF ANY OFFERING CIRCULAR OR OTHER SELLING LITERATURE.

Small issues give rise to a number of problems from the point of view of both private and public interest; particularly because a large percentage of the funds may be required to cover underwriting and other costs relating to a security offering. For example, in one recent offering of $300,000, the accompanying circular estimated that the underwriting commission would amount to $75,000 and that other expenses connected with the issue would be $25,250. Thus, about one-third of the funds raised from the public would not be available for use in the business; yet operations would be subject to the burden of earning a return on the entire amount of $300,000. Starting under such a handicap, it is not surprising that many new enterprises fail to survive.

Besides the problems of a business complexion, there are various perplexities related to the treatment of small investors. As a result, various proposals have been made, especially with respect to new so-called promotional companies or ventures, to give protection against the waste of

their funds. Under one arrangement, funds would be held in escrow with a provision for their return to subscribers unless 85 per cent of the securities are sold within six months.[23] Another plan would require a complete registration statement to be filed with the Securities and Exchange Commission irrespective of the size of the issue. Still another proposal would limit the commissions to 15 per cent of the offering price, or provide that the issuer and underwriter be required to return 85 per cent of the offering price to the subscribers upon failure to complete the sale of the securities within a reasonable period of time. A more general suggestion is that the Commission be given authority to stop or suspend the further sale of a small securities issue. At the same time, there is recognition of the principle that, "The raising of venture capital from the public should . . . not be stifled by unnecessary regulatory restrictions."[24] As of this time, none of these proposals has become law.

TRANSACTIONS EXEMPTED

After the initial or primary distribution of a security has been effected, ensuing transactions in the security become a form of trading rather than distribution. Trading transactions are covered mainly in the Securities Exchange Act, but the distinction between trading and distribution is pertinent here as a means of delimiting the scope of the Securities Act. To avoid unnecessary restriction of market activity, all transactions which are not a part of the primary distribution of a security are exempted. Thus, transactions by persons other than an issuer, underwriter, or dealer are exempted since they constitute trading in securities after their initial distribution. This exemption assures a market unfettered from registration and prospectus requirements for the sale and purchase of securities by the public, and this even though the original distribution of the security should be suspended by the Securities and Exchange Commission.

Transactions by a "dealer" (including an underwriter who is no longer acting in an underwriting capacity with respect to the security involved in the transaction, and including a broker, since the act defines a dealer to include a broker) are also free from the registration and prospectus requirements when they occur more than 40 days after the date of original offering to the public. An exception to this rule is found when the transactions relate to securities that are part of an unsold allotment left over from the original distribution. Since the primary distribution of a security usually is completed within 40 days, the provision covering trading by dealers is consistent with the policy of the act to regulate only the

---

[23] See *Wall Street Journal*, July 18, 1955, p. 4, reporting comments of the Chairman of the Securities and Exchange Commission.

[24] Andrew Downey Orrick, Commissioner, Securities and Exchange Commission, "SEC and Regulation A," *Commercial and Financial Chronicle*, January 5, 1956, p. 14.

distribution of securities and to avoid unnecessary interference with open-market activities. Similarly, ordinary brokerage transactions which are executed after the initial sale upon the unsolicited orders of customers need not be accompanied or preceded by a prospectus and may be engaged in without incurring possible civil liability because of the security being nonexempt and unregistered.

An important exemption, and one which has had marked influence on the distribution of securities in recent years, arises when no public offering is involved. This occurs when the issuing corporation itself disposes of a new issue by a private sale to one or only a few purchasers. Ordinarily, when an issue is disposed of by private negotiation, the purchasers will be institutional or other large and experienced investors capable of protecting themselves. Particularly prominent are the life insurance companies, which account for the entire bond financing of some corporations.

The line of differentiation between a public and a private offering is not always easy to draw. There is the question of how many purchasers would constitute a public offering; and, likewise, the point has been raised that even a single purchaser may later involve the public by redistribution. Another example is an offering to existing stockholders; and in one such instance, a court has held this to be a public offering within the meaning of the act, if the number of existing shareholders is large enough.[25]

It will be observed that the Securities Act fails to make certain exemptions which are commonly found in the state blue-sky laws. Some of these are as follows: (1) securities listed on the New York Stock Exchange and certain other national exchanges; (2) securities issued or guaranteed by foreign governments;[26] (3) securities of public utilities which are supervised by state officers or other state regulatory bodies.

REGISTRATION REQUIREMENTS

Schedule A of the Securities Act, which specifies the information that must be contained in the registration statement, contains 32 paragraphs. This of itself indicates something of the extent and quantity of information required. The following are some of the more important matters which the registration statement must contain:

1. A detailed balance sheet as of a date not more than ninety days prior to the date of the filing of the registration statement, and a profit and loss statement of the issuer for the latest fiscal year and each of the two preceding years. Forms are provided for each of these statements; and, in

[25] *Securities and Exchange Commission* v. *Sunbeam Gold Mines Co.*, 95 Fed. (2d) 699 (1938). The court examines, in its opinion, the legislative history of various provisions of the Securities Act in an effort to determine what the congressional intent was with respect to the meaning of the phrase "public offering."

[26] Pursuant to P.L. 142, 81st Cong., 1949, securities issued or guaranteed by the International Bank for Reconstruction and Development are exempt.

addition, most of the items must be supported with a schedule of underlying facts. Thus, a complete analysis must be made of the reserves, surplus accounts, etc.

2. A statement of the capital stock and funded debt both before and after the issuance of the new securities, including a description of their character and other pertinent facts with respect thereto. This necessitates an analysis of the various rights, provisions, etc., of the stock and bond issues.
3. A statement of the specific purposes for which the funds are to be raised and the approximate amounts to be devoted to each.
4. A complete account of the expenses of floating the issue, including the commissions to be paid underwriters and all other fees.
5. A full disclosure of the list of stockholders owning more than 10 per cent of any class of stock of the issuer or more than 10 per cent in the aggregate of the outstanding stock, and "full particulars of the nature and extent of the interest" of such stockholders, directors, and executive officers.
6. Salaries and other remuneration of directors and persons receiving in excess of $25,000 annually.
7. A disclosure of the persons to whom it is proposed to offer stock at less than the market price.
8. Copies of various documents, such as the certificate of incorporation; underlying agreements or indentures affecting any stock, bonds, or debentures; the agreement with the underwriters; contracts providing for special bonuses or profit-sharing arrangements; etc.

APPROVAL OF REGISTRATION STATEMENT BY THE COMMISSION

Unless earlier approval of a registration statement is given by the Securities and Exchange Commission, and if it raises no objection within a period of 20 days after filing, the statement becomes effective automatically. Review of the information by the Commission requires that consideration be given to such factors as: adequacy of information already available, complexity of the case, and protection of investors and the public interest. The time required to complete registration is naturally affected by the findings with respect to these items and the determination as to whether additional data or amended statements are necessary. Both the nature of the registration process and the required time may be seen in the record for the 1960 fiscal year. During that period the median time between the filing and effective date for 1,275 registration statements processed was 43 days. This time was divided among the three principal stages as follows: date of filing to the letter of comment by the Commission, 29 days; date of comment letter to filing of first material amendment, 8 days; and date of first amendment to effective date of registration, 6 days.[27] It is reported that the median elapsed time from the filing to the effective date of the registration statement was 28 days for fiscal year 1959, and 24 days for the previous year. The increase in time for fiscal 1960 was "due primarily to the cumulative effect of the unprecedented volume . . . particularly by issuers that had never before filed

[27] Securities and Exchange Commission, *Twenty-sixth Annual Report for the Fiscal Year Ended June 30, 1960*, pp. 31–32.

under the Act, and the lack of a sufficient number of examining personnel to process such a volume."[28] It may also be observed that practically all questions raised by the Commission are cleared by its letter of comment to which reference was previously made, but on infrequent occasion, there may be resort to a formal hearing.

Even after the registration statement has become effective, the Commission may, at any time after 15 days' notice and opportunity for hearing, issue a "stop order" suspending its effectiveness. This subsequent suspension may arise if it appears to the Commission that the registration statement includes any untrue statement of material fact or omits any material fact required to be stated therein, the result of which is to make the statement misleading. However, preliminary informal conferences between representatives of the issuer and the Commission have largely eliminated the need to suspend any registration statement.[29] Instead, corrective amendments are agreed upon; and suspensions are thereby avoided.

RIGHT TO WITHDRAW REGISTRATION STATEMENT

The right of the issuer to withdraw the registration statement after it is once filed has several times been the subject of litigation in the courts and of dispute before the Securities and Exchange Commission. The question is an important one, since if a registrant can withdraw his registration statement at will, he can prevent an investigation by the Commission and thus prevent fraudulent or misleading statements which he has made from being brought to light. The act provides that a registration statement may be withdrawn with the consent of the Commission "with due regard to the public interest and the protection of investors."

The question of the right to withdraw a registration statement first arose and was passed upon by the Supreme Court of the United States in *Jones* v. *Securities and Exchange Commission*.[30] The Commission had notified the issuer of its intention to conduct an investigation to determine whether or not a stop order suspending the effectiveness of the registration statement should be issued. In that case, the Supreme Court held that the Commission could not deny a registrant the right to withdraw his registration statement when no securities had been issued and the statement had not yet become effective. The court took the position that to permit an investigation under such circumstances would allow the Commission to exercise unconstitutional investigatory powers. The majority of the court, as opposed to the minority, apparently considered that the good that might result from an investigation in giving publicity

[28] *Ibid.*

[29] For example, only nine stop-orders were issued during the fiscal year ended June 30, 1960.

[30] 298 U.S. 1 (1936).

to attempted fraud, or in preventing a recurrence of a similar statement from the same registrant, was not sufficiently strong to support the Commission's finding that it was in the public interest to deny permission to withdraw.

The decision obviously limits the scope of influence of the Commission in investigating and unmasking fraudulent registrants who try to seek protection in retreat. In a vigorous dissenting opinion, three judges criticized the holding of the majority of the court. They said, in part:

> There are dangers in spreading a belief that untruths and half truths, designed to be passed on for the guidance of confiding buyers, are to be ranked as peccadillos, or even perhaps as part of the amenities of business. When wrongs such as these have been committed or attempted, they must be dragged to light and pilloried. To permit an offending registrant to stifle an inquiry by precipitate retreat on the eve of his exposure is to give immunity to guilt; to encourage falsehood and evasion; to invite the cunning and unscrupulous to gamble with detection. If withdrawal without leave may check investigation before securities have been issued, it may do as much thereafter, unless indeed consistency be thrown to the winds, for by the reaching of the decision withdrawal without leave is equivalent to a stop order, with the result that forthwith there is nothing to investigate. The statute and its sanctions become the sport of clever knaves.

Other decisions have, fortunately, presented a more liberal interpretation of the investigatory functions of the Commission and its power to determine what is in the interest of the public and investors. Thus, an order of the Commission refusing withdrawal of the registration statement after the effective date of the statement but before any shares were issued has been upheld by the courts.[31] And one case has even gone so far as to uphold the jurisdiction of the Securities and Exchange Commission to conduct an investigation and hearing to determine whether a stop order should be issued after all of the securities comprising the issue have been sold to the public.[32] The court pointed out that not only is the registration statement a condition precedent to the right of the issuer to use the mails and interstate commerce for the sale of the securities, but it is also, even after the original distribution, a vehicle of information for the investing public.

In the case just referred to, the court said, among other things:

> We do not agree with the contention that when all the securities had been disposed of by the issuer and its dealers the purpose of the registration statement was fully served and hence there was no need for a stop order. It does not follow when the securities pass out of the hands of the issuer and the dealers that they cease to be the subject-matter of sales in interstate commerce, and that the mails and facilities of interstate commerce cease to be used to effectuate their sales. In fact, the opposite is obviously true. Furthermore,

[31] *Resources Corporation International* v. *Securities and Exchange Commission*, 24 F. Supp. 580 (1938).

[32] *Oklahoma-Texas Trust* v. *Securities and Exchange Commission*, 100 Fed. (2d) 888 (1939).

members of the investing public might acquire the information contained in the registration statement during the time the securities are being sold by the issuer and its dealers, and might place reliance thereon in purchasing such securities from third persons after they have all passed out of the hands of the issuer and its dealers. Obviously, so long as the securities are outstanding, purchases thereof will continue to be made in reliance on the registration statement, unless notice of its unreliability is given by a stop order.

Such an attitude on the part of the courts bids fair to result in enforcing truthfulness in registration statements and in making them of real value as a continuing source of information beyond the period of original distribution.

PROSPECTUS—A SOURCE OF INFORMATION FOR INVESTORS

While the registration statement is intended as a primary source of information for the investor, there are limitations on its usefulness because of its bulky character as well as its comparative inaccessibility. To alleviate these shortcomings, the Securities and Exchange Commission has established public reference rooms at both its home and regional offices as well as making photostatic copies available. Even so, this does not provide a convenient or simple means for giving information to potential investors.

To assure wider distribution of the essential facts relating to new security issues, the law stipulates that a prospectus be given to every person solicited and to every purchaser either before or at the time of sale. The prospectus must contain, in condensed form, practically all of the information contained in the registration statement, except copies of counsel opinions, agreements, contracts, organization papers of the issuer, and the like. It is filed along with the registration statement so that it may be reviewed for adequacy and accuracy of content by the Securities and Exchange Commission. The Commission is, however, authorized to approve elimination from the prospectus of any information required in the registration statement which it feels to be unnecessary or inappropriate for the protection of the public or investors.

LIABILITIES—FALSE REGISTRATION STATEMENT OR FAILURE TO FILE

The requirements that relate to the offering and sale of new security issues obviously call for some means of effective enforcement. This is provided by the establishment of civil and criminal liabilities, as well as by empowering the Commission to investigate possible violations, to institute court action to enjoin violations, and to seek a court order compelling compliance with the act. Willful violation of any provision of the act or any rule of the Commission is made a penal offense subject to a maximum penalty of 5 years' imprisonment and a fine of $5,000. The

civil liabilities are more complicated, more technical, and hence more difficult for the layman clearly to understand. Yet study of the act would fall short of full understanding if attention were not given to the liabilities that attach to violation of its prohibitions or to failure to comply with its requirements.

First, liability may arise because of the failure of the seller to file a registration statement or to send a prospectus. In this event, an unconditional liability is established to refund the purchase price or to pay damages; but it runs in favor of the immediate purchaser only.

Second, liability may arise when the registration statement omits or makes an untrue statement of a "material fact required to be stated therein or necessary to make the statements therein not misleading." Prior to the amendments to the Securities Act made by the Securities Exchange Act of 1934, such a misstatement or omission gave rise to liability if the purchaser did not know of the untruth or omission at the time of the purchase. There was no need under the act as passed in 1933 for the purchaser to prove that he relied on the misstatement or omission in making the purchase. The Securities Exchange Act of 1934 made a considerable concession to the critics of this feature by amending the Securities Act so as to limit the blanket character of the liability. In brief, it provided that if the issuer had published an earnings report covering a full year, subsequent to the effective date of the registration statement, and if the purchaser had acquired his security after the earnings statement had been made so available, then he must prove that he acquired the security relying on the untrue statement or omission. That is the law as it exists today.

A seller who sells when no registration statement has been filed in accordance with the act, as was noted above, is liable only to the person purchasing the security from him and not to any subsequent purchaser. On the other hand, when a registration statement is in effect and the suit is based on a misstatement or omission therein, a remedy is given to all persons acquiring the security, even though it was not obtained directly from the person being sued. The extent of such liability is startling to all at first impression, and even studied thought emphasizes its broad coverage. Yet the continuing liability may be justified on the theory that information concerning a security given out at the time of flotation does not merely impress the immediate purchaser but has a profound influence on the general market opinion of the security.

PERSONS LIABLE

Among the more remarkable features of the act are the number and the diverse character of persons who are made liable for a false or misleading registration statement. The remedy runs not only against signatories of the registration statement, but also against

. . . (2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted; (3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner; (4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him; and (5) every underwriter with respect to such security.

Liability is also imposed upon "every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls" any of the persons enumerated above. Prior to the amendments made by the Securities Exchange Act of 1934, the liability of controlling persons was judged by the same standards as the liability of persons controlled. However, the Securities Exchange Act added an amendment that provided that controlling persons are not liable if "the controlling person had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist." The effect of this amendment is to assure the controlling person reasonable safety from liability unless he colludes in the misrepresentation or omission.

AVOIDANCE OF LIABILITY

The person being sued may avoid liability to the extent that he is able to prove that part or all of the depreciated value which caused a loss arose from causes other than the false statement or omission. Thus, neither the decline of security values as a result of adverse general market movements nor losses reflecting the decline of a specific field of industry are cause for liability. Moreover, even if there is a causal relationship between the defendant's loss and the misstatement or omission, the liability imposed is still not absolute, except as against the issuer. First, any one of the persons liable may avoid liability by showing that, before the effective date of the registration statement, he resigned from the office, capacity, or relationship in which he was described in the registration statement, and that he so notified the Commission. Second, if he can prove that the part of the registration statement with respect to which his liability is asserted became effective without his knowledge, he may avoid liability if he can show that, upon becoming aware of such fact, he resigned, notified the Commission, and gave public notice. Finally, he may escape liability by proving that, after reasonable investigation, he had reasonable grounds

to believe, and did believe at the time the registration statement became effective, that the statements therein were true and that there had been no failure to state any material facts.

The act prescribes that the test of reasonable investigation and reasonable grounds for belief in the accuracy of statement shall be "the standard of reasonableness . . . required of a prudent man in the management of his own property." Prior to the amendments made by the Securities Exchange Act of 1934, the standard of reasonableness was defined to mean that "required of a person occupying a fiduciary relationship." Opposition to the imposition of a fiduciary standard forced the amendment.

It is the policy of the Securities and Exchange Commission not to permit indemnification of directors for liabilities arising under the Securities Act of 1933. This may be seen in the following quoted language from the registration statement of the Cleveland Electric Illuminating Company.:[33]

> The Code of Regulations of the Company provides that each person who is or has been a director or officer of the Company shall be indemnified by the Company against expenses reasonably incurred by him in connection with any action, suit or proceeding in which he may be involved by reason of his being, or having been, a director or officer of the Company, except in relation to matters as to which he shall be adjudged in such action, suit or proceeding to be liable. The foregoing right of indemnification is in addition to any other rights to which any such director or officer may be entitled as a matter of law.
>
> In so far as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to officers and directors pursuant to the foregoing provisions or otherwise, the Company is advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and, therefore, unenforceable. In the event that a claim for such indemnification is asserted by an officer or a director, the Company will (unless the question has already been determined by a precedent deemed by the Company to be controlling) submit to a court of appropriate jurisdiction the question of whether or not indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of such issue.

Similar language appears in other registration statements wherever the question is pertinent; to early 1961, there has been no suit to test the Commission's policy.

DAMAGES RECOVERABLE FOR FALSE REGISTRATION STATEMENT

The amount of damages which may be recovered is, first of all, limited to the price at which the security was originally offered to the public. Within this basic limitation, damages may be recovered as follows: (1) the difference between the amount paid and the value of the security

[33] Registration Statement of the company, p. 31—filed in connection with the issuance in 1951 of its first-mortgage 3⅜ per cent bonds, due in 1986.

at the time of suit; or (2) the difference between the amount paid and the price obtained for the security when disposed of in the market before the suit was brought; or (3) the difference between the amount paid and the price at which the security was disposed of after the suit (but before judgment was rendered), if the damages calculated in this manner are less than those determined under (1).

CIVIL LIABILITIES FOR FALSE OR MISLEADING COMMUNICATIONS IN GENERAL

Civil liability under the act may arise other than from a false registration statement or a failure to file such a statement or to send a prospectus. Any person who sells a security by use of the mails or any other means of interstate commerce through the use of a prospectus or oral communication which includes an untrue statement of material fact or omits to state a material fact is liable, unless either of the following two conditions exists: (1) the purchaser knew of the untruth or omission; (2) the person being sued can prove that he did not know and, in the exercise of reasonable care, could not have known of the untruth or omission.

The remedy for this liability is the same as for failure to file a registration statement or to send a prospectus at all, namely, rescission of the sale and refund of the purchase price, or damages if the purchaser no longer owns the security. And, as in the case of failure to file a registration statement or send a prospectus, suit may be brought only by the immediate purchaser.

VALUE OF CIVIL-LIABILITY PROVISIONS

There has been much criticism of the civil-liability provisions of the Securities Act and considerable controversy as to their real value. Although it is difficult to give the precise number of civil-liability actions because of personal negotiations and settlements, it may be said that there have been less than 50 formal cases to date.[34] A number of these have not been finally adjudicated and, of course, could be either dropped or pursued further; recovery of funds was obtained in some 6 cases.[35] At the time the Securities Act of 1933 was enacted many fears were expressed that these potential liabilities would seriously restrain the free flow of investment funds; however, the intervening legal and financial record now reveals that there has been minimum disturbance. Still the worth of the

[34] To December 1, 1954, Louis Loss, *Securities Regulation, 1955 Supplement* (Boston: Little, Brown & Co., 1955), p. 984 shows a total of 38 formal cases of which 19 had been finally adjudicated with recovery of funds in only 4 cases; estimates since that date are based upon a review of the annual reports of the Securities and Exchange Commission.

[35] Estimate based on *ibid.*, and review of the annual reports of the Securities and Exchange Commission.

civil-liability features as an instrument of enforcement is probably not to be judged solely by the extent to which they have been utilized. They probably serve a more useful purpose as a deterrent to possible violations. Other means of enforcement are the investigatory powers of the Commission and its right to seek a court injunction against violation or to obtain a court order compelling compliance with the act.

APPRAISAL OF SECURITIES ACT OF 1933

It is to be expected that some opposition to governmental restraints and controls is inevitable. The Securities Act of 1933 is no exception, and the disgruntlement in financial quarters was particularly pronounced during the early years after its enactment. But over the years, increasing familiarity with its requirements has quieted the attack; and, today, they are generally accepted as a part of expected procedure. In the last analysis, little exception can be taken to the basic purpose of furnishing purchasers of newly issued securities with accurate information and facts; and the moral force of this objective remains unchallenged. Probably the inconvenience of complying with the rigid procedures provided for the registration of new securities has given some encouragement to direct financing which is exempt from the act, but the point cannot be proved by conclusive factual detail.[36] On the other hand, it is clear that the sale of many fraudulent issues has been prevented and that numerous investors have thereby been saved from loss.

There has been some disposition on the part of industry to regard registration as an additional burden in the form of unnecessary delay and expense; but again, the charge is not easily supported by pertinent statistics. This point has been pressed particularly in the case of small business; and it may have some merit, even though the ratio of SEC registration fees to the cost of financing shows no great variation according to the size of an issue.[37] However, it is likely that the burden may not be measured strictly on a dollar-and-cents basis and that the real problem may be found in the difficulties that small business has in engaging the

[36] The Securities and Exchange Commission expresses the opinion that "the real causes for the growth of private placements will be found in the unfolding of certain broad economic forces totally unrelated to the registration requirements of the Securities Act." See *Tenth Annual Report for the Fiscal Year Ended June 30, 1944* (Washington, D.C.: U.S. Government Printing Office), p. 6.

[37] See Securities and Exchange Commission, *Cost of Flotation, 1945–1949*, February, 1951, pp. 41–43, which shows that the average costs "entirely attributable to registration SEC fees" were 0.01 per cent of the gross proceeds for all size brackets of bonds, preferred stocks, and common stocks, except for a ratio of 0.02 per cent for common stock issues of less than $500,000. However, expenses partly affected by registration show a fairly pronounced inverse ratio between size and such expenses, ranging from 0.26 per cent for bonds of less than $500,000 to 0.02 per cent for issues of $50,000,000 and over; for preferred stock, from a high of 0.20 per cent on issues from $500,000 to $1,000,000 to a low of 0.01 per cent on issues of $50,000,000 and over; and on common stocks, from a high of 0.51 per cent on issues of $500,000 or less to a low of 0.05 per cent on issues from $10,000,000 to $20,000,000.

services of experts. In some respects, the registration requirement simply highlights or calls attention to the problem of size as such; but, in reality, the disadvantage is no different from that encountered in tapping the central money market for funds. Nevertheless, it is likely that the increase in the size of issues exempted, from $100,000 to $300,000, represents a special concession or a willingness to help small business.

During the war period, attention was naturally diverted from the Securities Act; but since that time, there has been little evidence to show that it has retarded legitimate financing in any way. Indeed, the volume of new security sales has reached new highs for both small- and large-scale business. With both economic and political acceptance, it is likely that the Securities Act of 1933 is now a permanent part of our financial structure.

QUESTIONS AND PROBLEMS

1. Discuss the responsibility of government for the regulation of security offerings. (*a*) Do you think it is necessary at all? (*b*) Should the size of the offering make a difference?
2. Do you believe that legislation should be enacted that would prevent a man from investing "money in a proposition to make gold out of sea water"? (See n. 21, page 387.)
3. Defend the philosophy of the statutes that are "designed only to prevent fraud, leaving it to the individual purchaser to determine, unhampered by fraud or misrepresentation, the wisdom of his purchase."
4. Discuss the problems of distinguishing between untrue statements and "rosy" promises; also evaluate the hazards of understatement as compared with overstatement of the facts.
5. "The trouble with most security legislation is the fact that it imposes higher standards on private securities than upon obligations of government." Discuss.
6. What is meant by the statement on page 384: "Looking beyond the historic policy of *caveat emptor*, he advocated a doctrine of 'let the seller also beware' "? Do you agree with this position?
7. Distinguish between the nature of a registration statement and a prospectus.
8. "Actually, fraud is more prevalent in small issues than in large flotations, and the exemption of the former from registration is simply sacrificing basic principle for the sake of expediency." Discuss.
9. Do you believe that the securities of public utilities, in view of the fact that their operations are under governmental supervision, should be exempted from registration requirements in the same way that those of banks and other financial institutions are excluded?
10. After clearance of the registration statement of the Globe Aircraft Corporation by the Securities and Exchange Commission early in 1946, underwriters sold 120,000 shares of its 5½ per cent cumulative convertible preferred stock. On December 31, 1946, the company was declared bankrupt; and, later, the Commission issued a stop order suspending the effectiveness of the registration statement. (See *Wall Street Journal*, September 26, 1947, p. 12, for further details.) Do you think that a stop order at that date had any significance? Do you think the Commission was remiss in passing

the registration statement of a company that went into bankruptcy so quickly?

11. Do you believe that issuers of securities should have the right to withdraw their registration statement in the event the Securities and Exchange Commission withholds its approval?
12. Would you favor an escrow arrangement for funds pending the successful sale of a security offering?
13. Would you favor legislation to limit the amount of commissions on the sale of new security offerings?
14. Do you think that issuers and other responsible parties should be equally as liable for omission as for misstatement of fact?
15. What are the chief arguments of private interests against the imposition of liabilities as outlined in the Securities Act?
16. Literally hundreds of uranium, electronic, and other types of companies with small public offerings during the past decade have gone into a "state of oblivion"; at least, there are no public sources from which current information may be obtained. Do you think that there is any practical means of protecting the public against such contingencies?

REFERENCES

ARMSTRONG, J. SINCLAIR, Chairman, Securities and Exchange Commission. "Current Developments at the SEC," *Commercial and Financial Chronicle*, Vol. 182, No. 5480 (November 10, 1955), pp. 8, 46.

BOSLAND, CHELCIE C. *Corporate Finance and Regulation*, chap. xi. New York: The Ronald Press Co., 1949.

"Extending the SEC Tent," *Business Week* (November 19, 1955), pp. 136–38.

GADSBY, EDWARD N. "The Practitioners' Approach before the S.E.C.," *Commercial and Financial Chronicle*, Vol. 192, No. 5992 (October 6, 1960), p. 10.

———. "Current Problems in the Vital Area of Securities Regulation," *Commercial and Financial Chronicle*, Vol. 191, No. 5946 (April 28, 1960), pp. 1, 28–29.

KOONTZ, H. D. *Government Control of Business*, chap. xxii. New York: Houghton Mifflin Co., 1941.

LOSS, LOUIS. *Securities Regulation*. Boston: Little, Brown & Co., 1951.

———. *Securities Regulation, 1955 Supplement*. Boston: Little, Brown & Co., 1955.

"New Look on a New Deal Baby," *Business Week* (September 17, 1955), pp. 154–58.

ORRICK, ANDREW DOWNEY, JR. "The SEC and the Fulbright Bill," *Commercial and Financial Chronicle*, Convention No., sec. 2 (October 6, 1955), pp. 8, 82–84.

ROHLFING, C. C., et al. *Business and Government*, chap. vii. Chicago: Foundation Press, Inc., 1941.

SMITH, R. S. "State 'Blue-Sky' Laws and the Federal Securities Acts," *Michigan Law Review*, Vol. XXXIV (June, 1936), pp. 1135–66.

Stevens on Corporations, sec. 177. St. Paul: West Publishing Co., 1936.

"The SEC and Financing of Small Business," *Commercial and Financial Chronicle*, Vol. 183, No. 5510 (February 23, 1956), pp. 3, 31.

WOOD, HAROLD E. "The NASD and the Fulbright Bill," *Commercial and Financial Chronicle*, Convention No., sec. 2 (October 6, 1955), pp. 9, 78–81.

Chapter 21 ►

EXISTING SECURITIES AND THEIR REGULATION

THE PROVISION of capital for corporations is much more than a matter of the preliminary sale of new securities. The continued carrying of the securities after they are issued is of even greater importance. It is true that once the corporation has obtained the funds, it is not expected to liquidate stock; whereas bonds are intended to be retired only on the basis of the terms of their issue. However, this does not mean that investors are supposed to forego their own interests for those of the corporation; rather, they expect to be able to shift their investments whenever they may desire. Consequently, it is most important that facilities be provided for the sale of existing securities; otherwise, there would be little prospect of their sale in the first instance. As we know, trading in securities takes place on a large scale; and we may note the characteristics of the two main forms of such activity: (1) over-the-counter dealings and (2) trading on organized exchanges.

OVER-THE-COUNTER DEALINGS

Originally the term "over-the-counter" denoted its literal meaning—the sale of securities over the counters of private banking houses.[1] Today, it represents a market organization consisting of trading facilities provided by dealers and brokers in securities. Through personal contact and the use of telephone, telegraph and teletype communication, buyers and sellers are brought together so that the aggregate result constitutes an efficient and well-organized market. In effect, all securities transactions outside the organized exchanges are deemed to be on the over-the-counter market.

The need for such facilities may be appreciated by first noting that

[1] Staff Report to the Committee on Banking and Currency, United States Senate, *Factors Affecting the Stock Market* (Washington, D.C.: U.S. Government Printing Office, 1955), p. 152.

there are about 1,000,000 corporations in operation; however, it is estimated that "less than 1 per cent of these corporations appear to have the size and share distribution to command a continuing public market for their stocks."[2] Since only 2,584 companies (as of June 30, 1960) have their securities listed on securities exchanges, it is apparent that the securities of most corporations are traded on the over-the-counter market.

Measured in the aggregate—number of issues, number of transactions and dollar volume—"the over-the-counter market dwarfs the total exchange markets."[3] The sale of all offerings of new securities is effected through the facilities of the over-the-counter market and practically all trading in federal, state and municipal issues takes place in a similar manner. It is estimated that about 80 per cent of the purchase and sale of corporate bonds is made on the over-the-counter market; but its volume and activity in corporate stocks are greatly exceeded by trading on the floor of the exchanges.

Despite the greater activity in stocks on the exchanges, the role of the over-the-counter market in such securities is by no means unimportant. On the contrary, it makes a market for the host of unlisted issues. Transactions in as many as 8,000 to 10,000 issues may take place in a single day, while as many as 30,000 may be traded with some frequency during the course of a year.[4] The issues of companies listed on organized exchanges total 4,246, of which 3,018 are stocks (common and preferred) and 1,228 are bonds.

While it is true that there are a host of companies traded over the counter which are not nationally known, there are also many sizable and prominent corporations in this category. Among the many examples are those shown in Table 38. The companies reported here and many more would meet the requirements for listing on the New York Stock Exchange, such as: assets, more than $2,000,000; shares, 300,000 or more outstanding; annual earnings, in excess of $1,000,000; and number of stockholders, 1,500 or more.

There are a number of reasons why corporate management may elect to have their securities traded on the over-the-counter market rather than on organized exchanges. The decision may reflect a desire to avoid the reporting and publication of information required of listed securities and to maintain the greater privacy afforded by an unlisted status. Again, there may be distaste for the speculative activity which listing may generate.

---

[2] Securities and Exchange Commission, *Twenty-fifth Annual Report for the Fiscal Year Ended June 30, 1959* (Washington, D.C.: U.S. Government Printing Office), p. 65.

[3] Staff Report, *op. cit.*, p. 152.

[4] Ira U. Cobleigh, "Over-the-Counter Supermarket for Largest Choice of Securities," *Commercial and Financial Chronicle*, Vol. 192, No. 5996 (October 20, 1960), p. 26.

On the securities exchanges, prices are determined by auction while, on the over-the-counter market, they are mainly the result of negotiation. Dealers acquire an inventory of securities in which they are interested (commonly referred to as taking a *position* in the particular securities) and then attempt to negotiate their sale. Responses also come from other dealers acting in their own behalf or representing parties seeking to buy the securities. The bid and ask prices resulting from the negotiation previously mentioned provide a continuing basis to appraise the reasonableness of purchase solicitations.

Dealers seek to make their profits like any other merchant—by marking up the price of the article purchased. In this instance, the difference between the purchase and sale price is known as the "spread" and is intended to cover the commission or return for the dealers' services. Except on stocks selling for less than $10 a share, the National Association of Securities Dealers discourages "commissions that total more than 5 per

TABLE 38

COMMON STOCKS OF SELECTED COMPANIES TRADED OVER THE COUNTER*
(Data as of December 31, 1959, or Nearest Date)

Name of Company	Assets	Number of Shares Outstanding	Number of Shareholders	Price Range in 1959
Weyerhaeuser Co.	$568,331,656	30,271,133	11,300	48¾–39⅞
Ralston Purina Co.	201,871,147	6,488,506	7,450	52¼–42
Time, Inc.	216,480,399	1,955,779	10,740	75–63¼
Pabst Brewing Co.	103,648,281	4,363,927	8,097	14⅞–9¼
Texas Eastern Transmission Corp.†	879,124,109	8,899,964	59,172	36½–26½

* Source: *Moody's Manuals.*
† Now listed on the New York Stock Exchange, the first trading in the stock taking place on June 14, 1961.

cent from both buyer and seller for any one transaction."[5] Since there is no published record of actual transactions, as is the case with the securities exchanges, the point is made that the less-informed buyer may be the victim of unwarranted markups by the seller. However, both legal restraint and surveillance by the National Association of Securities Dealers serve to deter abuse.

With respect to legal protection, dealers generally have a duty not to take advantage of their customers. This principle was applied to dealers in securities for the first time in 1943 in the case of *Charles Hughes & Co.* v. *Securities and Exchange Commission.*[6] The court declared in its decision that:

> An over-the-counter firm which actively solicits customers and then sells them securities at prices as far above the market as were those which peti-

[5] "The Other Bull Market," *Forbes,* November 15, 1955, p. 20.

[6] 139 F. 2d 434 (C.A.I., 1943).

tioner charged here must be deemed to commit a fraud. It holds itself out as competent to advise in the premises, and it should disclose the market price if sales are to be made substantially above that level. Even considering petitioner as a principal in a simple vendor-purchaser transaction, it was still under a special duty, in view of its expert knowledge and proffered advice, not to take advantage of its customers' ignorance of market conditions. The key to the success of all of petitioner's dealings was the confidence in itself which it managed to instill in the customers. Once that confidence was established, the failure to reveal the markup pocketed by the firm was both an omission to state a material fact and a fraudulent device. When nothing was said about market price, the natural implication in the untutored minds of the purchasers was that the price asked was close to the market. The law of fraud knows no difference between express representation on the one hand and implied misrepresentation or concealment on the other.

In this case, a price of 25 per cent above the market was held to be unreasonable, but the court did not state what could be charged.[7]

At best, resort to the law is an inconvenient and expensive remedy, and protection to investors should be furnished by proper safeguards inherent in the operations themselves. This is one of the major purposes of the National Association of Securities Dealers, commonly known as NASD. Dealers and brokers of standing have long recognized the importance of rules of fair conduct, both in their own interest as well as that of the public. But a trade organization with power to carry out this objective was not feasible until 1938, when Section 15(a), often known as the Maloney Act, was added to the Securities Exchange Act. It authorized the organization of voluntary national securities associations to supervise the conduct of their members. In turn, these associations must register with the Securities and Exchange Commission and be subject to regulation by the Commission. The NASD is the only organization of its type that meets these requirements. In brief, it "is a private organization with public responsibilities."

As of June 30, 1960, the NASD had 4,373 members, or more than 80 per cent of the 5,239 brokers and dealers who were registered with the Commission as of the same date.[8] The country is divided into 14 districts which elect a central board of 31 governors. In each district, the members elect a district committee of not more than 12 members, which in turn appoints a district business conduct committee. The latter "has the major burden of enforcing the association's rules of fair practice," and the members are inspected regularly to check their compliance. It is reported that as of a recent date, about one-third of the members are examined annually.[9] Corrective actions taken by the NASD are subject to review by the SEC and, of course, by the courts.

---

[7] Staff Report, *op. cit.*, p. 159.

[8] Securities and Exchange Commission, *Twenty-sixth Annual Report for the Fiscal Year Ended June 30, 1960* (Washington, D.C.: U.S. Government Printing Office), pp. 117, 245.

[9] Staff Report, *op. cit.*, p. 161.

Despite the foregoing protective provisions, the requirements with respect to various features are much less onerous for companies whose securities are traded exclusively on the over-the-counter market than for those whose issues are listed on stock exchanges. Criticizing this "double standard" of regulation the president of the Midwest Stock Exchange mentioned such differences as the reporting of officers' salaries and bonuses, publication of financial statements, and controls over inside trading.[10] Although there is as yet no statutory enactment, the Senate Banking and Currency Committee expressed "the view that as a general policy, it is in the public interest that companies whose stocks are traded over the counter be required to comply with the same statutory provisions and the same rules and regulations as companies whose stocks are listed on national securities exchanges."[11]

THE SECURITIES EXCHANGES

Securities exchanges are privately organized markets which are used to facilitate trading in securities. In order to qualify, the securities must be approved for listing, although trading privileges may sometimes be extended to unlisted issues. Such exchanges are found in most of the large cities, but the New York Stock Exchange is by far the largest. Of the trading on all registered exchanges in registered securities during the year ended December 31, 1959, it accounted for $45,367,620,000 out of a total of $53,877,250,000.[12] Only three of the remaining 13 registered exchanges (including the New Orleans Exchange which ceased operations on October 30, 1959) had a volume in excess of $1,000,000,000—the American Exchange on which transactions had a market value of $4,982,-019,000, the Midwest Exchange with trading of $1,390,758,000, and the Pacific Coast Exchange with a volume of $1,007,647,000. Also, the great bulk of the trading in registered securities was represented by stocks, amounting to $51,863,625,000, or about 96 per cent of the total. As stated previously, bonds are traded over the counter much more extensively than stocks, irrespective of whether they are listed.

Not only does listing provide a market for the investor, but also a number of protective services are added. The protective services do not exist to the extent of a guaranty, but they do help to assure the presence of good faith and to reduce the possibility of fraud. Specifications are set forth as to the form and content of stocks, bonds, and other financial instruments; and even the quality of the paper used to issue the certifi-

[10] *Stock Market Study*, Report together with Individual Views and Minority Views of the Committee on Banking and Currency, 84th Cong., 1st sess. (Washington, D.C.: U.S. Government Printing Office, 1955), p. 9.

[11] *Ibid.*

[12] Securities and Exchange Commission, *Twenty-sixth Annual Report for the Fiscal Year Ended June 30, 1960* (Washington, D.C.: U.S. Government Printing Office), p. 248.

cates is stipulated. Likewise, the requirement of a transfer agent and a registrar provides both service and safety to the investor. The transfer agent's chief duty is to cancel old and to issue new stock, although he (usually a trust company) frequently renders such additional services as mailing dividends, distributing various corporate reports, etc. It is the duty of the registrar to check the amount of stock issued and to assure its legitimacy.

FUNCTIONS OF SECURITIES EXCHANGES

Securities exchanges provide many direct benefits to investors and the listed corporations, and contribute to the workings of the larger economy. With respect to investors, recognized values are established which are useful for measuring capital gains as well as for tax-reporting purposes.[18] Such values also serve as one benchmark for corporations interested in effecting mergers or other forms of property transfer.

Among the more important and broader economic functions are the following:

Directing the Flow of Capital. While the exchanges are seldom used directly to raise funds for corporations, they do exert great influence upon the channels through which funds flow. They function like a traffic signal, indicating a green light when certain fields offer the necessary inducement to attract capital and blazing a red light when the outlook for new investment is not attractive. Influence upon the flow of capital investment is accomplished by the prices established in the market for the individual securities and by their relative yields. Unfavorable or unprofitable conditions are the cause of lower prices, whereas a promising outlook acts as a stimulus in raising security prices. Obviously, the resulting yields will bear an inverse relationship to the price. Unattractive fields are likely to have low-priced securities with high-income yields, or no yield at all. Along similar lines, market conditions and responses also indicate the type of security issues which is in demand.

Facilitating the Distribution of New Security Issues. As stated previously, new financing is not accomplished through the media of securities exchanges; instead, the corporation taps new sources of capital by direct negotiation with institutional investors or indirectly by offerings to the public by means of specialized underwriting and selling agencies. Considering only the latter, large corporations usually sell outright to investment bankers, who, in turn, sell to the public, whereas small businesses employ agents on a commission basis. Not only does listing encourage public participation because of the facilities afforded to dispose of the securities, but it also aids the selling medium to carry the securi-

[18] Especially is this true with respect to inheritance and estate taxes, where difficulties may be encountered in establishing values because of the absence of active trading in the securities.

ties prior to their final sale by making them more acceptable as collateral for loans.

Elevating Corporate Standards. Security exchanges tend to raise the plane of financial practice because standards of behavior tend to be elevated in any type of organized activity. In the field of securities, as in the sports world, the creation of a league or conference results in the establishment of operating standards; and a mechanism is provided to deal with those parties who do not conform to the accepted practices.

Furnishing a Means of Publicity. Organized exchanges play an important part in affording publicity to corporate information. It should be pointed out, however, that they do not gather or guarantee the validity of news that is given out in connection with their operation. However, the exchanges do provide a centralization of trading in securities which directly facilitates the assembly and dissemination of news relating to the financial events of the day. In addition, the exchanges compel those companies whose securities are listed to publish periodical financial statements as well as certain other data which may be pertinent to the operation of the companies.

NEED FOR REGULATION OF EXCHANGES AND EXISTING SECURITIES

Despite the cherished wish that self-government might serve as a sufficient force of regulation, the need for governmental supervision of broad fiduciary relationships has been demonstrated on more than one occasion. Personalities tend to retard aggressive corrective action under private regulation, and there is a tendency to shield those who are in power. Illustrative of the point is the failure of the New York Stock Exchange to take early action against its former president, Richard Whitney. Despite the fact that his firm was insolvent for at least three and one-half years, its suspension was postponed until there was little escape from taking action. Among other things, Whitney had used the funds of his firm for personal speculation in ventures with such "diverse products as applejack, peat humus, and mineral colloids."[14] Even within the four months prior to suspension, he was able to negotiate 111 loans amounting to $27,361,500,[15] and as early as 1926, he had misappropriated a customer's securities.[16] Whether or not supervision by the government can eliminate such bad practices is by no means a certainty, but at least there can be no

---

[14] Securities and Exchange Commission, *Tenth Annual Report for the Fiscal Year Ended June 30, 1944* (Washington, D.C.: U.S. Government Printing Office), p. 19.

[15] *Ibid.*, p. 20.

[16] *Ibid.*, p. 19. Pleading guilty to two separate indictments charging him with grand larceny in the first degree, Whitney "was sentenced on April 11, 1938, to an indeterminate term of five to ten years on each indictment.

challenge of the point that honest and sound practice by brokers and securities dealers is essential to both private and public interest.

The assurance of adequate and reliable information about securities is equally vital to the protection of investment operations. In this respect, there is no difference between the need for data covering new securities and existing issues. Not only should there be proper reporting of the facts relating to the financial position of corporations, but, in addition, it is equally necessary with respect to trading in securities. Manipulative practices may easily give a false impression of the volume of trading transactions and distort the merits of a security just as much as the omission or false declaration of material facts in connection with the original distribution. Similarly, artificial or primed price changes may be the cause of undue influence and inspire the investor to act unwisely. The effects of such abuses are particularly significant because it is in the trading area that the important distribution of securities to the public at large really begins. Initial purchasers frequently buy in large blocks and often with the deliberate intention of early resale; hence, the need for protection of investors may be greater at the time of later distribution than at the time of initial sale.

To eliminate the foregoing abuses as well as to provide surveillance of market operations generally, the Securities Exchange Act of 1934 supplements the Securities Act of 1933 in two principal ways: (1) by providing continuing publicity and reliable information about the current financial condition of the issuers of securities bought and sold on the principal stock exchanges in the United States; (2) by prohibiting certain practices which tend to create fictitious values for securities. In addition, authority was granted to the Securities and Exchange Commission to regulate over-the-counter sales by the adoption of the so-called "Maloney Amendment" in 1938. As discussed earlier, the primary task of supervision is carried out by the National Association of Securities Dealers subject to review by the Securities and Exchange Commission. Our attention may now be directed to the regulation of stock exchanges and the listed companies. Since the largest and best known securities market is the New York Stock Exchange, our remarks will be based primarily upon this particular organization.

MECHANISM OF THE STOCK EXCHANGE

To appreciate the workings of the Securities Exchange Act, it is helpful to get an insight into the mechanism of the New York Stock Exchange. In brief, the exchange is an agency that serves to bring together the many elements which are involved in the purchase and sale of securities. The diversity of its operations may be suggested by noting the four principal types of members, who alone are authorized to engage in floor trading:

1. *The Commission Broker.* The commission broker is a member of the stock exchange who devotes his time and efforts to the execution of buying and selling orders for the brokerage firm which he represents. This brokerage firm, in turn, acts for a great many buyers and sellers distributed all over the country. The commission broker does not own the securities bought or sold; his function is strictly one of acting as an impartial medium to bring together the supply and demand.

2. *The Odd-Lot Broker.* Since the standard unit of trading in stocks on the New York Stock Exchange is 100 shares, special facilities are necessary to take care of orders placed by small investors. This function is fulfilled by odd-lot dealers, who have special brokers on the floor of the exchange to handle this business.

3. *The Floor-Trader.* The floor-trader acts in the capacity of a principal, i.e., he deals for his own account. His position is essentially that of a securities merchant, since he owns the securities in which he deals; and his profits or losses arise out of changes in price levels of the securities that he owns or has promised to deliver at some later date. In general, he plays the market for quick turns and is seldom interested in any long-term developments and trends. Often, he buys his securities in the morning and sells at the end of the trading day so that he has no holdings to carry overnight.

4. *The Specialist.* The specialist is an individual who may combine both the trader and broker functions but concentrates his efforts upon only a few stocks in a given industry. He may, in the case of important issues, limit himself to trading in a single issue. His position arises out of the necessity of having some means for handling orders placed at specific prices other than the prevailing price. Orders placed to buy or sell at market are handled promptly and with relatively simple problems of bookkeeping. However, orders placed at a definite price above or below market must be filed so that they will be executed whenever the market reaches the specified price. It is the function of the specialist to keep a record of all such orders and to execute them as it becomes possible to do so. Possessing, as he does, wide information as to the state of the market, it is quite apparent that the function of the specialist is susceptible to abuse. This becomes especially true when it is remembered that he exercises both brokerage and trading functions and is, therefore, in a position to buy or sell in his own or a "straw" name while conducting the brokerage business.

ADMINISTRATION AND PURPOSES OF THE SECURITIES EXCHANGE ACT

The Securities Exchange Act of 1934 created the now well-known Securities and Exchange Commission to administer that act, the Securities Act of 1933, and certain other federal laws relating to securities and

many other features of corporation finance.[17] The Commission has broad power to regulate the securities markets and the activities of their members by its rules and regulations and has broad discretionary powers in other matters. As a result, its interpretations and the vigor of its enforcement of the statutory provisions under which it operates largely determine the true meaning of the following purposes of the act of 1934:

1. General regulation of exchanges and members, brokers, and dealers for the protection of investors and in the public interest.
2. Prevention of manipulative devices and provision for the maintenance of an honestly conducted market.
3. Restriction of trading on inside information by persons possessing such information.
4. Publication of systematic and reliable information as to the management and financial condition of corporations whose securities are listed on an exchange.
5. Limitation of excessive speculation in securities, primarily through regulation of the amount of credit which may flow into speculative channels.

REGISTRATION OF EXCHANGES

Effective supervision and elevation of securities standards depend, first of all, upon the qualification and conduct of the front-line operating units. These are accomplished by requiring that all national security exchanges must be registered with, and approved by, the Securities and Exchange Commission.[18] In applying for registration, the exchange must furnish "such data as to its organization, rules of procedure, and membership, and such other information as the Commission may by rules and regulations require as being necessary or appropriate in the public interest or for the protection of investors." This is a distinct innovation in the affairs of these organizations. Prior to the passage of this law, the New York Stock Exchange, for example, had never given publicity to its financial statement. Now, along with all other registered exchanges, it is required to submit annually a balance sheet and an income and expense statement for the year, although the Commission may use its judgment about releasing this information to the public.

Another prerequisite for registration is the existence of rules of the exchange which provide for the expulsion, suspension, or disciplining of

[17] In addition to the Securities Act and the Securities Exchange Act, the Commission administers the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisers Act of 1940, and has certain functions in connection with corporate reorganizations under the 1938 amendment to the federal Bankruptcy Act (the Chandler Act).

[18] The act does not directly require such registration but indirectly compels it as a result of the prohibition in Section 5 of the act against use of the mails or the instrumentalities of interstate commerce by a dealer, broker, or exchange for the purpose of employing the facilities of a securities exchange, unless the exchange is registered as a national securities exchange or, by reason of the limited volume of transactions effected on it, is exempt from such registration.

members for conduct "inconsistent with just and equitable principles of trade." Most exchanges have always had such rules; but, to strengthen them, the act requires that they must also provide that failure to abide by the provisions of the Securities Exchange Act or any regulation of the Commission shall be regarded as an act of misconduct subject to the penalties that the rules provide for other violations. Upon becoming registered, an exchange must agree to comply with the provisions of the act and any rule or regulation promulgated thereunder. In addition, it must agree to compel, within the limits of its powers, its members to give the same compliance.

The exchanges are also required to assist in carrying the expense entailed by registration and the ensuing supervision. The act imposes upon all registered exchanges a yearly registration fee amounting to five one-hundredths of one per cent of the total volume of sales for that year. The bulk of this assessment falls upon the New York Stock Exchange because it is by far the largest single securities exchange in the country.

REGULATION OF EXCHANGE MEMBERS

In considering the regulation of stock exchange members as provided under the Securities Exchange Act, we may remind ourselves that our primary objective is to gain an appreciation of the indirect financial significance of such regulation more than to understand the details and intricacies of speculation and the technicalities of trading. The latter constitute an area that lends itself more particularly to the well-known study of investments. At the same time, we may not overlook the important fact that trading on the New York Stock Exchange plays a major part in keynoting the entire money market. Reckless and unbridled speculation can play havoc with sound financing and may even be the cause of the failure of a corporation. Stock market activities also do much to set the standards for the sale of new securities and have great effect upon the whole pattern of financing. In the words of the act, regulation and control of transactions in securities are deemed to be necessary "to protect interstate commerce, the national credit, . . . to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets. . . ."[19]

Only rarely does any industry ask to be regulated, and it is not surprising that considerable controversy arose over the question of the need for regulating members of a stock exchange. One of the most debated points was the segregation or limitation of the operations of brokers, specialists, and dealers. The principle as to whether an individual or firm could properly serve as both broker and dealer was at stake. To pose the underlying question in more direct terms: Can a broker represent fairly

[19] Sec. 2.

the interests of a client if he is also, in fact, the dealer who owns the securities that are to be sold?

As passed, the Securities Exchange Act imposed no categorical segregation of dealer and broker functions either on or off the floor of the exchanges but, in large part, referred the problem to the Commission. The act empowers the Commission to prescribe such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors, to regulate or prevent floor-trading on the exchanges, and to prevent such excessive trading off the floor by exchange members for their own account as the Commission "may deem detrimental to the maintenance of a fair and orderly market."[20] It is provided that such rules and regulations may exempt transactions by odd-lot dealers and specialists in accordance with the rules and regulations that the Commission may prescribe. When not in contravention of rules and regulations of the Commission, the rules of a national securities exchange may permit the exchange to register a member as an odd-lot dealer or a specialist.

So far as the segregation provisions of the Securities Exchange Act relate to the activities of securities houses off the floor of the exchange, they represent almost a total victory for the opponents of segregation. The act neither prescribes segregation of dealer and broker functions for outside securities firms nor permits the Commission to prescribe such segregation by rules and regulations. The provisions of the act merely provide:

1. That a broker-dealer may not extend credit to a customer on any security bought from him if such security was part of a new issue in the distribution of which he participated within a period of six months prior to the customer's purchase of the security.
2. That a member who is both a broker and dealer must disclose to a customer, in writing, at or before the completion of the transaction, the capacity in which he is acting.

The Commission was directed to "make a study of the feasibility and advisability of the complete segregation of the functions of broker and dealer." This study was submitted to Congress in June, 1936. With respect to the segregation of functions on the floor of the exchange, the Commission reached the following two general conclusions:

1. That the combination of the broker and dealer functions in the same individual or firm involves a conflict of interest which is provocative of abuse of the fiduciary relationship inherent in the brokerage function;
2. That the survey made by the Commission manifests the prevalence upon the exchanges of a type of dealer activity which exerts an undue influence on prices, incites public speculation, leads to disorderly mar-

[20] Floor-trading no longer has the importance it had in earlier years, partly because trading on small margins is no longer possible. This, combined with tightened rules enacted by the stock exchange itself, has made it unnecessary for the Securities and Exchange Commission to enact rules and regulations on this subject.

kets and interferes with the effective fulfillment of the brokerage function.[21]

However, the Commission stated that it did not believe complete segregation advisable at that time and that further study of the subject would be necessary. The report then set forth a proposed program.

With respect to the abuses of nonsegregation of dealer and broker functions off the floor of the exchange, the Commission's report was much less critical and confined itself largely to proposals for restricting undue speculative trading.

MANIPULATIVE PRACTICES AND SEC INSPECTIONS

One or another provision of the act is directed at the various and elusive manipulative devices which serve to create an artificial market for stocks. There is no need to recite all the practices that have been used to achieve this result, but, for the sake of example, we will briefly mention two types. One is the use of "wash sales" or "matched orders" in which the buying and selling interests are one and the same, although they are usually disguised by the use of "straw names." The purpose, of course, is to create the appearance of activity in the stock. Another is the dissemination of false or misleading information or tips in order to arouse speculative interest. Not surprisingly, such operations are prohibited by the statute.

Other forms of speculative practice are not barred by the terms of the act itself but are made unlawful only if in contravention of any rules and regulations of the Commission. For example, operations which are intended to fix, or even stabilize, prices are subject to such enactments. Also, restrictions are placed on short sales. Under this form of speculative practice, the speculator borrows stock for sale in the expectation that the price will drop; the replacement of the borrowed stock is then effected by a later purchase. The risks of such a transaction are apparent, and it is equally clear that short selling in volume may affect the behavior of the stock market. Hence, the objective of the Commission's rules and regulations is to free the market from pressures that would distort the expression of genuine demand and supply influences.

SEC Inspections. Besides utilizing the services of the NASD to which reference was made earlier in this chapter, the SEC also places great emphasis on its own "program of broker-dealer inspections."[22] These inspections generally include the following:[23]

1. *Analysis of broker-dealer's financial condition.* Under its "net capital rule" the SEC looks with disfavor upon indebtedness which exceeds twenty

[21] Securities and Exchange Commission, *Report on the Feasibility and Advisability for the Complete Segregation of the Functions of Dealer and Broker* (Washington, D.C.: U.S. Government Printing Office, 1936), p. 109.

[22] *1960 Report, op. cit.*, p. 114.

[23] *Ibid.*, p. 115.

times the net capital of the broker-dealer. Any offender is notified of the deficiency and given an opportunity to correct the condition; failure to do so may result in revocation of the broker-dealer's registration.

2. *Review of pricing practices.* As the entitlement suggests, consideration is given to the practices of broker-dealers in the pricing of securities sold to the public. In the fiscal year ended June 30, 1960, it was found that unreasonable prices appeared in 194 cases; for the previous fiscal year, 255 instances were reported.

3. *Evaluation of safeguards to protect customers' funds and securities.* Failure to keep proper books and records is the most common of all the deficiencies found. Some 967 cases were reported in fiscal year 1960, and 1,081 cases in fiscal year 1959. Attention is also given to custodial and other related features.

4. *Adequacy and accuracy of disclosures to customers.* Consistent with one of the primary objectives of federal legislation relating to securities, the SEC inspectors scrutinize the operations of broker-dealers to determine the adequacy and accuracy of disclosure of information relating to transactions with their customers.

During the fiscal year ended June 30, 1960, the SEC made 1,499 inspections, or somewhat less than 30 per cent of the total number of registered brokers and dealers. Fortunately, the value of such inspections may not be measured alone by physical coverage; probably more important is the immeasurable psychological influence which serves to deter malpractices. Also, it should be said that a private code of ethics is of even greater import in maintaining a high standard of conduct in dealing with other people's money and securities.

TRADING BY INSIDERS

The theme of trusteeship and fair dealing which runs so consistently throughout both the Securities Act of 1933 and the Securities Exchange Act of 1934 is particularly apparent in Section 16 of the latter. Under its provisions, each beneficial owner of more than 10 per cent of any class of a registered equity security, and each director and officer of the issuing corporation, is required to file a statement of his stockholdings and to report any changes at the end of each calendar month. Furthermore, it is provided (Subsection [*b*]) that any profits realized by them in the purchase and sale of securities of the corporation, which are consummated within a period of less than six months, "shall inure to and be recoverable by the issuer." Short selling by any of these close interests is absolutely prohibited (Subsection [*c*]); other persons, however, may sell short under rules and regulations promulgated by the Commission.

During the fiscal year ended June 30, 1960, the SEC received 37,496 reports covering the holdings and transactions of insiders.[24] The reports are available for public inspection and are often given widespread publicity. While the general public is apt to give considerable weight to activities of this type, their significance can easily be misleading because of

[24] *1960 Report, op. cit.,* p. 85.

the absence of knowledge relating to the underlying motivations. At times, there may be a simple desire to act in order to obtain tax advantages or because of other personal reasons; at other times, the actions may reflect the exercise of options to purchase stock at favorable prices which are not available to outsiders. In any event, the reports of transactions by insiders do serve to vitalize an important aspect of modern financial management—the public disclosure of the information.

FILING OF CORPORATE DATA

Prior to the passage of the Securities Exchange Act, the public received, with respect to many corporations, neither adequate data nor information with sufficient timeliness to give it currency. Some of the leading corporations did not publish their financial statements more than once a year, and even these would not be forthcoming until well after the close of the financial period reported. Some protection was afforded investors by the listing requirements of the stock exchanges; and the New York Stock Exchange, particularly, had accomplished much in setting higher standards as to the corporate information which should be available to the public.[25] The Securities Act of 1933 required adequate information in connection with the issuance of a new security. But neither stock exchange listing requirements nor the Securities Act provided adequately for securities already issued and listed. The issuance of a prospectus applied only to new security issues and did not cover those already in existence. It was the need for continuing information on already outstanding securities which the publicity features of the Securities Exchange Act were designed to meet.

The act requires that securities listed on exchanges, or admitted to unlisted trading privileges after enactment, be registered before they can be traded in on any exchange. Registration consists of filing by the issuer, with the Commission and the exchange, such information as the Commission may in its rules and regulations require as to the following items:

(A) the organization, financial structure and nature of the business;
(B) the terms, position, rights, and privileges of the different classes of securities outstanding;
(C) the terms on which their securities are to be, and during the preceding three years have been, offered to the public or otherwise;
(D) the directors, officers, and underwriters, and each security holder of record holding more than 10 per centum of any class of any equity security of the issuer (other than an exempted security), their remuneration and their interests in the securities of, and their material contracts with, the issuer and any person directly or indirectly controlling or controlled by, or under direct or indirect common control with, the issuer;

[25] For a discussion of the New York Stock Exchange listing requirements, see Twentieth Century Fund, Inc., *The Security Markets* (New York, 1935), pp. 235–37, 592–609.

(E) remuneration to others than directors and officers exceeding $20,000 per annum;
(F) bonus and profit-sharing arrangements;
(G) management and service contracts;
(H) options existing or to be created in respect to their securities;
(I) balance sheets for not more than the three preceding fiscal years, certified if required by the rules and regulations of the Commission by independent public accountants;
(J) profit and loss statements for not more than the three preceding fiscal years, certified if required by the rules and regulations of the Commission by independent public accountants; and
(K) any further financial statements which the Commission may deem necessary or appropriate for the protection of investors.[26]

The issuer must also file such copies of articles of incorporation, by-laws, trust indentures, underwriting arrangements, voting trust agreements, and other similar documents as the Commission may "require as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security."

PERIODIC REPORTS

The act empowers the Commission to require every issuer of a listed security to file with the exchange and with the Commission (1) such information and documents as the Commission may require to keep reasonably current the information and documents filed in or with the registration statement; (2) such annual reports certified by independent public accountants, if required by the rules and regulations of the Commission, and such quarterly reports as the Commission may prescribe.[27] This is in line with the policy of the act to secure continuing information on the corporations that are issuers of registered securities.

The Commission is given authority to prescribe the form in which required information shall be submitted and, in this connection, to prescribe the system and methods of accounting to be used in the preparation of reports. It is hoped that this will not only result in standardization of reports but that it will also facilitate and tend to promote uniform accounting. The lack of standardized accounting terminology and the existence of marked variances in accounting theory have always been a deterrent to financial interpretation. The Commission is presented with an opportunity to solve personal disagreements as to accounting treatment and render a service of value to the accounting profession and financial interests alike. Allowance will have to be made for different industrial categories; but within any single group, reasonable uniformity should eventually be achieved.

---

[26] Sec. 12 (*b*) (1).

[27] Only annual reports were required until June 30, 1955, at which time provision was made, with certain exceptions, for regular filing of semiannual reports.

OPPOSITION TO PUBLICITY

While the major opposition to the Securities Exchange Act has centered on other provisions, there has been considerable objection to the parts of the act requiring adequate publicity and disclosure of corporate affairs. Opponents of the publicity features argue, first of all, that such provisions do not logically belong in an act to regulate stock exchanges. However, as noted earlier in this chapter, two of the primary economic functions of a securities exchange are to supply means for evaluating the worth of securities and to provide media for the investment of accumulated savings in corporate securities. Obviously, complete disclosure and publicity of pertinent information about the corporations whose securities are listed on these exchanges should facilitate the performance of these functions.

Another objection made to the publicity requirements of the act is that they encroach upon the domain and functions of private management. The answer to this objection lies in the nature of the modern corporation. The growing separation of ownership and control has increased the fiduciary obligation which corporate management owes to members of the investing public.[28] From this larger point of view, one of the responsibilities of management must be to make available adequate information with respect to the condition of the companies under its control.

Any person may make objection to the public disclosure of any information contained in applications, reports, etc., filed by him; and in such case, the Commission may make the information available to the public only when "in its judgment a disclosure of such information is in the public interest." The constitutionality of delegating to the Commission the power to publicize or to withhold information was attacked in the courts in a case involving the American Sumatra Tobacco Corporation.[29] The tobacco corporation had asked the Commission for permission to withhold publication of information in its registration statement showing the amount of gross sales and the cost of goods sold. It contended that disclosure of its gross profit margin, which was larger than that of most other corporations, would cause resentment on the part of customers and result in damage and loss by creating a buyers' strike. The Commission denied the corporation's request, and the court upheld the Commission's action. The tobacco firm had argued that Congress had delegated power to the Commission without setting any standard for the Commission's action, the words "public interest," it was asserted, being too general for that purpose. To this contention, the court replied as follows:

---

[28] See discussion of the legal and social responsibilities of management in Chapter 16.

[29] *American Sumatra Tobacco Corporation* v. *Securities and Exchange Commission*, 110 F. (2d) 117 (1939).

Petitioner says the words "public interest" are too general to be a proper safeguard, but we think this point is without merit. The main purpose of the Act is to insure the maintenance of fair and honest markets in transactions in securities on national exchanges. The Act requires the issuer of securities—the registrant—to make disclosures in order to forestall unfair practices in the sale of securities and for the protection of investors. The "public interest" in this respect is just as definite as the "public interest" in transportation facilities. Power of the Interstate Commerce Commission to make decisions, confined only by the latter standard, have been continually upheld . . . . we think the Act provides a sufficient guide for administrative action whenever the commission is called upon to decide whether or not disclosure is in the public interest.

EFFECT OF SPECULATION ON CREDIT

Economists are by no means in agreement as to whether or not speculation deprives industry of credit. Irrespective of this, the point of view expressed in the Securities Exchange Act is clear, for it attempts to check excessive speculation and regulates the amount of credit which may flow into speculative securities transactions. This is done by correcting or limiting the two exchange practices which have been criticized as most encouraging to speculation, namely, short selling and margin trading. Previous reference was made to the former, and the controls affecting the latter may now be noted.

Margin trading attracted much attention both in and out of Congress when the enactment of the Securities Exchange Act was under consideration. Some advocated complete prohibition of margin trading, but this was regarded as being too deflationary in character. There is little question that such a drastic step would seriously restrict the securities market. The act attempts to solve the problem through control over the extension of margin credit. This control is effected chiefly by two means: (1) limitation on the amount of credit that may be extended or maintained for the purpose of purchasing or carrying securities; (2) regulation of loans to brokers and of the agencies that make such loans.

The act provides that credit may be extended in a margin transaction in an "amount not greater than whichever is the higher" of the following: (1) 55 per cent of the current market price of the security; or (2) 100 per cent of the lowest price during the preceding 36 calendar months, but in no event to be in excess of 75 per cent of the current market price. In order to provide flexibility, the Federal Reserve Board is given the authority to prescribe lower margin requirements if they are deemed necessary or appropriate for the accommodation of commerce or industry, or higher margin requirements if they are deemed necessary to prevent excessive use of credit to finance securities transactions. The Federal Reserve Board, acting under this authority, has since modified the margin requirements to as low as 25 per cent of the current market price and as high as 100 per cent.

There are several provisions designed to regulate loans to brokers and to regulate the many agencies which grant such loans. Members of registered exchanges and other persons doing business with a member may not borrow from any source other than a member bank of the Federal Reserve System or a nonmember bank which has filed an agreement with the Federal Reserve Board to comply with the provisions of the act and the Board's rules and regulations relative to the use of credit in financing security transactions. A broker's total indebtedness to all other persons is restricted to such percentage of his net capital as the Commission may prescribe and in any event to an amount not greater than twenty times his net capital. Restrictions are also placed on the hypothecation by a broker of his customer's securities.

ENFORCEMENT OF THE ACT

To secure effective enforcement of the act, both criminal and civil liabilities are provided. Willful violation of any provision of the act or properly issued rule or regulation is made subject to fine and imprisonment. Civil liability may arise from misleading statements in a variety of documents or from willful participation in prohibited manipulative practices. Liability arising out of a false or misleading statement attaches to any person who makes or is responsible for making the statement. The liability runs in favor of any person who, in reliance on the statement, purchased or sold a security at a price that was affected by this statement. Any actual damages suffered by reason of such reliance may be recovered unless the person sued can prove that he acted in good faith and had no knowledge that the statement was false or misleading.

In addition to the criminal- and civil-liability features, the act contains numerous other provisions designed to empower the Commission to enforce the act. The Commission, upon complaint or upon its own initiative, may (1) investigate possible violations of the act, (2) bring suit to enjoin threatened violations, and (3) seek a court order to compel compliance with the act. For violation of any provision of the act or any of the rules and regulations of the Commission, the Commission may (1) suspend or withdraw altogether the license of any exchange, (2) withdraw the registration statement of any security, or (3) suspend or expel from an exchange any member or officer thereof.

The Commission is authorized, if in its opinion the public interest so requires, to suspend trading in any registered security for not more than 10 days and, with the approval of the President, to suspend trading on any exchange for a period not exceeding 90 days. The Commission is given the power to request changes in the rules of an exchange, and if such changes are not made voluntarily, to alter or supplement the rules of the exchange for the "protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administra-

tion of such exchange." Every contract made in violation of the act or any rule or regulation of the Commission and contracts binding any person to waive compliance with the act or rules and regulations issued under it are nullified.

APPRAISAL OF THE SECURITIES EXCHANGE ACT

An appraisal of the results of the Securities Exchange Act indicates that undoubtedly many sharp trading practices in securities have been eliminated. Of great significance, too, is the assurance given by the publication of more accurate and comprehensive information about corporate affairs. The public reaction to these changes may not be measured in quantitative terms, but it is probable that more studied analysis of investment and speculative dealings now exists. Some years ago one authority said: "Heretofore, people bought securities like commodites on the commodity exchange. They made up their minds and came in and placed an order. It was simply a mechanical matter. Now they want the time and the knowledge of an investment advisor."[30] Another stated: "People just come in and buy a stock and that's the end of it. . . . There is hardly any trading."[31] However, both the trading and price trends in recent years reflect both public interest and volume; indeed, stock market activity as of this writing (April, 1961) is at such heights as to evoke warnings from eminent authorities, including the president of the New York Stock Exchange. At least, however, we do not have the perils of the past arising out of thin, marginal purchases, and the problem is essentially one of extreme speculative enthusiasm or outburst.

Both historical review and current evaluation give many evidences that the functioning of the Securities Exchange Act is of benefit to the economy as a whole. Particularly have the evils of concealment been restrained; conversely, disclosure by required publicity has brought into play the invigorating force of public scrutiny. There may be the familiar criticism of restraint upon the freedom of individual action; on the other hand, the equally important and accompanying responsibility for the results of such action is made vigorously effective by enforcement of the Securities Exchange Act.

QUESTIONS AND PROBLEMS

1. "To a ruggedly individualist-handful of corporate executives, the over-the-counter market . . . is one of the last refuges for corporations who do not want to reveal certain facts and figures of their businesses." (*Forbes*, November 15, 1955, p. 19.) Discuss.

---

[30] *Wall Street Journal*, October 9, 1947, quoting Dr. W. W. Cumberland, a member of the Board of Governors of the New York Stock Exchange.

[31] *Ibid.*, quoting a partner in an unnamed West Coast brokerage firm.

2. (*a*) Do you think that the same requirements for the publication of information should be applied equally against both unlisted and listed companies? (*b*) Would you make exceptions based upon the size of the corporation or the number of stockholders?
3. Some companies avoid "listing on a stock exchange in the hope of insulating their shares from some of the daily ups and downs of speculation." (*Forbes, op. cit.*, p. 19.) Discuss.
4. Distinguish carefully between the characteristics of trading in the over-the-counter market and of that which takes place in organized security exchanges.
5. Discuss the importance of securities exchanges as a force in the raising of capital.
6. Would you favor a policy of encouraging more extensive listing with local exchanges, or do you believe that the concentration in the New York Stock Exchange is preferable?
7. Section 2 (4) of the Securities Exchange Act, in supporting the necessity for regulation, states the effect of speculation as follows: "National emergencies which produce widespread unemployment and the dislocation of trade, transportation, and industry . . . and adversely affect the public welfare, are precipitated, intensified, and prolonged . . . by excessive speculation." Discuss.
8. Distinguish between the possible short-term and long-term effects of speculation on the financing of corporations.
9. What are the essential differences between dealer and brokerage functions? Do you think that the conflict of interest between the two is such as to affect adversely the interests of investors?
10. Discuss the significance of inspection of broker-dealer operations by the SEC. Do you believe that self-regulation as provided by the NASD should be sufficient?
11. Do you believe that the registration of private security exchanges is warranted in the interest of the public and of investors?
12. The determination of prices for listed securities should be a "function free of practices which tend to create fictitious values" both for "the protection of investors and the continued flow of funds into corporate financing." Discuss the general relationship between speculation and the financing of corporations.
13. Distinguish between the general nature of buying securities on margin and the arrangement for purchase on the installment basis of any other commodity.
14. Do you believe that the flow of credit into speculative channels should be regulated any more than its use in other fields of activity?
15. To what extent should corporations be compelled to make corporate affairs a matter of public record?
16. Appraise the argument of the American Sumatra Tobacco Corporation set forth on page 419.

REFERENCES

Armstrong, J. Sinclair, Chairman, Securities and Exchange Commission. "Current Developments at the SEC," *Commercial and Financial Chronicle*, Vol. 182, No. 5480 (November 10, 1955), pp. 8, 46.

BOSLAND, CHELCIE C. *Corporate Finance and Regulation*, chap. xi. New York: The Ronald Press Co., 1949.

COBLEIGH, IRA U. "The Over-the-Counter Market Fills the Needs of All Investors," *Commercial and Financial Chronicle*, Vol. 191, No. 5940 (April 7, 1960), pp. 1, 26–50; "Over-the-Counter Supermarket for Largest Choice of Securities," *ibid.*, Vol. 192, No. 5996 (October 20, 1960), pp. 1, 26–50; "Over-the-Counter Market—National Shopping Center for Securities," *ibid.*, Vol. 193, No. 6046 (April 13, 1961), pp. 1, 26–52.

DICE, CHARLES A., and EITEMAN, W. J. *The Stock Market.* New York: McGraw-Hill Book Co., Inc., 1952.

FRIEND, IRWIN, HOFFMAN, G. W., and WINN, W. J. *The Over-the-Counter Securities Markets.* New York: McGraw-Hill Book Co., 1958.

"Insider Deals in the Spotlight," *Business Week* (May 28, 1955), pp. 52–58.

KOONTZ, H. D. *Government Control of Business*, chap. xxiii. New York: Houghton Mifflin Co., 1941.

LOSS, LOUIS. *Securities Regulation.* Boston: Little, Brown & Co., 1951.

———. *Securities Regulation, 1955 Supplement.* Boston: Little, Brown & Co., 1955.

SECURITIES AND EXCHANGE COMMISSION. *Report on the Feasibility and Advisability for the Complete Segregation of the Functions of Dealer and Broker.* Washington, D.C.: U.S. Government Printing Office, 1936.

SHULTZ, B. E. *The Securities Market.* New York: Harper & Brothers, 1942.

"Stock Exchange Practices." *Hearings before Subcommittee on Banking and Currency, U.S. Senate (72d Cong., 2d sess.).*

TWENTIETH CENTURY FUND, INC. *The Security Markets.* New York, 1935.

PART V ►

Income and Working Capital

Chapter 22 ►

ANALYSIS OF CORPORATE INCOME

THE PRECEDING chapters have dealt with activities that involve relationships between the corporation and its owners and other outside parties. For the most part, we have been concerned with the long-term phases of operations or with the composition of the structure of finance. Now, the dynamic side may be considered, wherein the structure is put to work, the elements of change and turnover become more prominent, and the income results require analysis. In a word, the corporation is "in business."

Investors are obviously affected by the results of operations, but they have little active contact with this day-to-day functioning of the corporate enterprise. It is essentially the province of management, under whose leadership the business battle is conducted. Individual stockholders with ownership rights have no voice because only the stockholders as a group can act. The latter elect a board of directors which, in turn, selects the chief executive officers to carry on the actual operations. Usually, the president is a member of the board of directors; and in this capacity, he sponsors and guides the policies necessary for the conduct of business. Moreover, there is often great delegation of power to operating heads so that they have full responsibility for many decisions which materially influence the success or failure of the corporation.

The specific problems in this operating area are manifold, but they may be classified simply into production, sales, and administration. Consideration will be given only to the last category and then only to its financial phases. The following are the more important subjects calling for analysis: the general nature and administration of income; the provision of adequate working capital; the formulation of dividend policies; the establishment of sufficient reserves and surplus to provide a margin of safety; and, in view of the extent to which it has become a public question, the compensation of executives. Such issues as these have to do with current operations as distinguished from the problems of capital structure which have heretofore been studied. The analysis of current activities necessarily calls for greater emphasis upon the management point of

view; but, at the same time, the importance of public and investor interests cannot be ignored.

EARNINGS ON THE INVESTMENT

The primary test of the earnings position is provided by relating income to the capital committed to the enterprise. From the broad economic point of view, this should be the relationship between earnings and the total investment as measured by the firm's total capitalization, i.e., stocks, surplus, and funded debt—in other words the total money values committed to the enterprise. This approach gives us a measure of the over-all, financial success of the business without regard to ownership. If we are interested in the comparative profitability of different lines of industry or of different firms within an industry, the total investment approach is the only practicable one. The reason for this can be demonstrated most readily by an example. Two corporations, A and B, are engaged in the same industry and have a capital structure as follows:

Capital Structure	A	B
Funded debt (6 per cent)	$4,000,000	$1,000,000
Stock and surplus	6,000,000	9,000,000

Assuming the same net income, it is evident that different results would be obtained if funded debt were omitted. If the average rate paid on the funded debt were 6 per cent in both cases, and if net income were $1,000,000, the following results would be obtained:

Capital Structure	A	B
Net income	$1,000,000	$1,000,000
Interest	240,000	60,000
Available for stock	$ 760,000	$ 940,000
Percentage on stock investment	12.6	10.4

Actually, each has earned a like return of 10 per cent upon the total investment, so that the foregoing procedure would be misleading for comparative purposes. From the standpoint of the stockholder, however, the foregoing method is acceptable, since he is interested only in what is earned on his investment. Frequently, he would be apt to omit the surplus figure as a part of investment; but for reasons which have already been discussed, surplus should be included.

EARNINGS ON THE STOCKHOLDERS' EQUITY

The ratio of net earnings to the stockholders' equity is more widely and popularly used as a measure of corporate success. In this ratio, the

net earnings after all charges, including interest on funded debt and income taxes, are compared with the stockholders' equity. As the term is used in finance, "equity" refers to the portion of the corporation's resources contributed by the stockholders. This is evidenced on the balance sheet by the preferred and common stock accounts plus surplus and certain reserves. Sometimes, the term "equity" is used more narrowly as applying only to the common stock, surplus, and certain reserves. In general, all reserves representing appropriations of surplus for policy purposes should be included. Reserves representing provision for future, irregular, or probable expenses should not be included.

As illustrations of the varying problem of measuring stockholders' equity, the liability section of the balance sheets of two of the largest corporations may be summarized. The report of the Allied Chemical and Dye Corporation is presented below:

ALLIED CHEMICAL AND DYE CORPORATION

December 31, 1955

Current liabilities	$ 79,757,679
Pensions and contingencies reserve	40,256,777
Insurance reserves	1,127,051
Sundry reserves	331,604
Common stock	47,910,795
Capital surplus	126,764,353
Earned surplus	228,597,458
	$524,745,717

The only item in this balance sheet which can be definitely excluded from stockholders' equity is that of current liabilities. Since the reserves were accumulated directly from earnings or through appropriations of surplus, they should be included in stockholders' equity. An exception to this statement might be made; to the extent to which the above reserves include provision for liabilities known to exist, they are no longer truly representative of equity. However, such amounts are not likely to be important qualifications in this case, except as to the amount set aside for pensions. The 1960 report of the same corporation (now known as The Allied Chemical Corporation) showed the addition of long-term debt and the elimination of capital surplus which had been transferred to the common stock account. Sundry reserves had also been eliminated.

The 1955 balance sheet of Swift and Company is something of a contrast. Here it is clearly spelled out that the reserves are, in fact, a part of stockholders' equity which had been set aside to give recognition to possible financial hazards. The 1960 balance sheet continues only the general reserve; the others have been closed out. This action is an example of how financial policy shifts to anticipate or to meet changing economic conditions. A period of relative stability in price levels does not make the eliminated reserves as essential for conservative management.[1]

[1] See Chapter 25 for discussion of reserves.

The ratio of earnings on stockholders' equity is usually preferred for two reasons: (1) management (and investors) likes to give primary consideration to earnings results from the viewpoint of the legal owners,

SWIFT AND COMPANY

October 29, 1955

Current liabilities	$117,167,531
Long-term debt	46,500,000
Capital stock outstanding	150,000,000
Accumulated earnings (after providing for following reserves)	185,170,694
General reserve	13,237,031
Reserve for high-cost additions to fixed assets	27,000,000
Reserve for inventory price declines	5,767,000
	$544,842,256

i.e., the stockholders; and (2) the full effect of public policies or changing economic conditions is most pronounced in the share of income remaining for the stockholder interest. This is demonstrated in part by data shown in Table 39.

TABLE 39

RATIO OF NET EARNINGS TO STOCKHOLDERS' EQUITY OF LEADING CORPORATIONS, 1949–50, 1954–55, AND 1959–60*

NUMBER OF COMPANIES			GROUP	PERCENTAGE RATIO OF EARNINGS TO EQUITY†					
1949–50	1954–55	1959–60		1949	1950	1954	1955	1959	1960
22	19	16	Baking	17.8	16.1	11.4	11.9	11.5	11.4
15	17	13	Soft drinks	16.5	15.5	12.4	14.1	17.1	15.6
27	20	14	Brewing	22.1	14.7	8.2	6.5	7.8	8.1
13	12	13	Distilling	15.2	17.9	6.5	6.4	8.0	7.3
33	48	53	Clothing and apparel	8.1	10.7	5.0	7.0	10.5	10.0
26	30	25	Tires and rubber products	8.7	15.7	11.9	15.1	12.9	10.6
28	27	26	Lumber	10.7	16.2	9.7	14.2	11.7	8.0
34	24	29	Drugs, etc.	16.2	21.5	14.8	18.3	22.0	20.0
30	32	22	Cement	18.8	18.2	18.6	20.3	16.0	11.3
26	15	17	Autos and trucks	30.2	32.3	18.0	29.1	16.9	15.8
64	64	53	Automobile parts	18.9	22.7	10.4	15.3	13.1	8.7
27	41	43	Aircraft and parts	8.2	14.1	27.1	24.7	9.0	6.1
17	25	47	Chain stores—food	18.2	17.9	13.6	13.4	14.0	13.0
57	54	59	Chain stores—other	12.3	13.2	8.4	10.6	10.5	8.5

* National City Bank, *Monthly Letter on Economic Conditions and Government Finance*, April, 1951, p. 44. *Ibid.*, April, 1956, p. 43. *Ibid.*, April, 1961, p. 41.

† The tabulation from which these data are derived captions this item as "return on net assets," which is the equivalent of stockholders' equity. A note to the caption reads as follows: "Book net assets at the beginning of each year are based upon the excess of total balance sheet assets over liabilities; the amounts at which assets are carried on the books are far below present day values." In other words, the above ratios reflect earnings on the *investment* rather than earnings on "*worth.*"

The data are influenced by factors such as volume of sales, availability of material, and presence or absence of work stoppages. However, the most significant single factor influencing the 1950 results was the advent of the Korean War in June of that year. This event had a marked effect

on virtually every line of activity. Sales volume increased substantially in durable-goods lines; prices and costs rose in differing degrees. Most corporations were able to increase their net income after taxes in spite of substantial increases in such taxes. Others suffered because of materials dislocations and changing price relationships.

The later period represents a different set of circumstances in a more peaceful aspect of the cold war. The year 1954 was one of recession and readjustment for many companies. In contrast, 1955 was the most profitable year in the country's history for the economy as a whole. Many companies continued to be plagued, however, with labor troubles, high costs, high taxes, and increasing competition. This competition for the consumer's dollar found reflection not only among individual companies, but industries as well. The manner in which the various industries were able to meet this challenge is reflected to some extent in the data in Table 39.

Perhaps the greatest contrast in earning trends is offered by the companion groups autos and trucks, and automobile parts. The shrinkage in numbers of companies in the former group is a well-told story. While a greater relative number of automobile parts manufacturers has survived, here too, attrition has taken its toll. Inroads on the profits of many of the survivors have been severe, although, as nearly always, several companies made out very well. As Table 39 indicates, profits in the 1954–55 period did not reach the levels of 1949–50, although 1955 showed a substantial gain for the entire group, in comparison with 1954. The 1959–60 period showed even poorer profit results than 1954 as automobile production fell and competitive pressures became more severe. Being suppliers to a fabulously rich industry does not always insure fabulous profits to the suppliers. The purchasers of the industry's suppliers drive hard bargains, as is well known. Of course there are only two or three giants in the automobile industry and of these General Motors Corporation stands alone. Its business philosophy and policy, as outlined to the Joint Economic Committee of the United States Congress makes instructive and fascinating reading.[2] It is only pertinent at this point to note that the settled policy of the management is to price its products so as to make an average of at least 20 per cent on its capital. In 1955 it made nearly 28 per cent. In the same year, as also in 1954, many of the company's dealers were struggling against bankruptcy. The reason the company can adopt and generally realize such a profit policy is that it does not sell directly to the public. It sells to a group of dealers under franchise to it. General Motors determines the price the dealer must pay it. The public has a good deal to say about the true price the dealer will

[2] *Hearings before the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary, United States Senate (84th Cong., 1st sess.*, Parts VI, VII, and VIII [Washington, D.C.: U.S. Government Printing Office, 1955]). See e.g., Part VII, pp. 3583 ff.

get for his car. While the manufacturing corporation may have a large measure of market influence, it is not entirely immune to fluctuations. During the 1941–60 period, earnings on General Motors common varied between \$0.29 and \$4.30 per share. In 1958, it missed its 20 per cent on capital target substantially when it reported less than 13 per cent. In 1959 and 1960, it earned approximately 16.5 per cent on capital.

OTHER BASES FOR MEASURING CORPORATE INCOME

While earnings in relation to the capitalized investment are usually regarded as the most realistic basis for comparing results, other bases may be more appropriate. A usual variation is to state earnings as a percentage of sales. This is done in the case of corporations having a small investment base or a high turnover of the investment resulting in an abnormally high rate of return on the investment. It is also done to illustrate how thin the margin of profit is and how easily it can be wiped out through managerial error or economic fluctuation. For instance, in 1950, a group of food chains reported a net return on the stockholders' equity of 17.9 per cent; but this return was obtained from a net profit margin of only 1.7 per cent of sales. In 1960, by contrast, net return had declined to 13.0 per cent, on a net profit margin of only 1.3 per cent of sales.[8] The erosion of high costs, competition, and the relative degree of flexibility in prices under differing economic conditions is also reflected in the results of six mail-order concerns. In 1950, they reported a net return on net worth of 18.3 per cent, derived from a net margin on sales of 5.7 per cent. The comparable results in 1960, a year of good business, if not a booming prosperity for many companies, were 10.1 per cent, from a reduced net margin on sales of 2.1 per cent.

Another reason for the use of the earnings-to-sales basis is the fact that most business managers are accustomed to thinking in terms of margins and ratios based on the operating statement. If a net profit of 2 per cent of sales is thought proper, then every effort will be made to attain this figure, even though 1½ per cent accompanied by unusual sales volume may be yielding an entirely satisfactory return on investment. Whatever the reason for the use of this basis, earnings as a percentage of sales will always appear smaller than earnings as a percentage of investment. This has been particularly true of the years since 1940. As prices have risen, sales, expense, and profits figures have followed; but capital values, as reflected in balance sheets, have risen more slowly. The lag in adjustment of capital values has resulted in distorted ratios of earnings to equity. It will take many years of price stability to correct this distortion. On the other hand, the ratio of earnings to sales involves no comparable upward bias.

[8] First National City Bank, *Monthly Letter on Business and Economic Conditions*, April, 1961, p. 41.

In the last twenty years, corporations have frequently had occasion to point out how small earnings were in relation to wage payments; and during the periods in which the excess profits tax has been in effect, they have shown how small earnings were in relation to total tax payments. Such comparisons have been made for publicity purposes, for dramatizing the relatively small share of total income available as a return to the investor, and for showing the impact of wartime and defense taxation.

EFFECT OF MANAGEMENT POLICY ON INCOME

In making any appraisal of corporate income, it is necessary to recognize the considerable influence which management policy may have upon the reported results. Reported income is the product of an accounting process, but accounting is not as yet a science or a closed system of logic. Considerable latitude for management discretion exists in defining such items as "depreciation," "deferred maintenance," or "provision for anticipated losses on inventory." Even expenditure items may be handled so as to introduce distortions and noncomparability between industrial groups, companies, and even the same company from year to year. Illustrative of the importance of management policy on reported income is the case of May Department Stores Company, which wrote off part of its depreciable assets in 1933. It then shifted from a policy of making annual charges for depreciation to charging capital additions directly to expense. In 1943, it reversed itself and returned to a policy of capitalizing its equipment purchases and making annual charges for depreciation. The effect on reported earnings was substantial. Both good accounting practice and the regulations of the Securities and Exchange Commission require that marked changes in accounting methods be indicated in the annual report.

The Chrysler Corporation profit and loss statements for the years shown in Table 40 furnish examples of the difficulties in comparing reported net income during recent years. Reported net earnings for 1946 reflected a decline of over $10,000,000 from the previous year. The fact that the decline was no greater was due to an income tax adjustment credit of $8,000,000, the disappearance of interest requirements, and the reduction in federal taxes. On the other hand, the company took into earnings from plant rehabilitation reserves only about one fourth as much as in the preceding year. Between 1949 and 1950, the decline in reported net income was due almost entirely to increases in federal taxation. In 1954, interest charges reappeaared and continued to grow as the company found it necessary to borrow in response to competitive pressures in the market. In 1959–60, a new account is provided to give recognition to the risks involved in foreign operations. In 1959, a tax credit served to halve the company's small deficit.

The many variations found in practice among the corporations are

usually the result of differences in opinion as to the current methods for handling reports and of variations in industry practices. At other times, they may rise from a desire to make a good showing or to manipulate operating results. The existence of this discretionary element in the accounting system makes it imperative that the student give some attention to the items most subject to the influence of management judgment. Among these should be mentioned maintenance, depreciation, amortiza-

TABLE 40

CHRYSLER CORPORATION COMPARATIVE PROFIT AND LOSS STATEMENT
(000,000 Omitted)

	1945	*1946*	*1949*	*1950*	*1954*	*1955*	*1959*	*1960*
Net sales	$994*	$870	$2,085	$2,191	$2,072	$3,466	$2,643	$3,007
Other income	1	1	16	17	2	4	11	10
	$995	$871	$2,101	$2,208	$2,074	$3,470	$2,654	$3,017
Cost of products sold, other than items below	$901†	$766	$1,772	$1,824	$1,820	$2,938	$2,299	$2,598
Depreciation of plant and equipment	‡	21	19	20	50	55	72	73
Administrative, engineering, selling, advertising, service and general expenses	36	50	87	90	159	219	238	229
Pension and retirement plans	...	...	...	11	26	21	40	35
Provision for incentive compensation	2	1	8	11	Cr. 3	9	...	...‖
Interest on long-term debt	...	...	...	...	1	4	9	9
Interest paid	1§	...	...	...	...	...	...	...
Fees and interest paid under bank agreement credit	1	1	...¶	...	...	...	...	...
Provision for extraordinary risks pertaining to foreign operations	...	...	...	...	...	...	6	6
U.S. and foreign taxes on income:								
Normal tax and surtax / Excess profits tax	21**	14**	81**	123**	3	125	Cr. 5	34
Income tax adjustment††	Cr. 1	Cr. 8	...	..	...	...	...	...
Plant rehabilitation, etc.§§	Cr. 4	Cr. 1	...	...	...	...	...	...
	$958	$845	$1,969	$2,080	$2,055	$3,370	$2,659	$2,985
Net earnings	$ 37	$ 26	$ 132	$ 128	$ 19	$ 100	def. $5	$ 32

* Including billable costs and fees under cost-plus-fixed-fee contracts.
† Including costs under cost-plus-fixed-fee contracts.
‡ Depreciation and amortization equal to $9,532,749 not reported separately.
§ Interest on advance paid under war contract.
‖ Less than $1 million ($512,663).
¶ This amount ($256,000) too small to show in this calculation.
** These amounts were reported as one sum and as "Federal income and excess profits taxes."
†† Recovery of previous years taxes from use of unused excess profits tax credit.
§§ Portion of reserves for reconversion expenses restored to income.

tion, the valuation of assets, and provisions for undetermined expenses such as bad debts. With the factor of accounting variability in mind, we may approach a brief consideration of the fundamental factors affecting income by type of industry.

STABLE-INCOME INDUSTRIES

Many industries are characterized by a relatively stable flow of income. Here, the tasks of management are simplified because the element of stability facilitates long-range planning and the budgeting of expenditures. Instead of dealing constantly with the unexpected, an orderly financial program may be arranged. The task of building a sound capital structure is made easier, and problems in the operating area are con-

siderably reduced. Desirable as stable income is, it is not achieved through the medium of managerial policy. Management may relieve the problem, and it may take farsighted steps tending toward greater stability; but it cannot eliminate fluctuating incomes at will. Some industries will naturally be variable in character, whereas others offer a more constant rate of income. The determining factors are found mainly in the type and in the nature of the products or services handled. In general, it will be found that the following characteristcs tend to promote stability of gross income: (1) necessity goods and services; (2) retail trade, especially low-priced goods which appeal to an extremely wide market, such as five-and-ten-cent stores. However, as the variety stores widen their merchandise lines and offer higher-priced goods, the degree of stability will be reduced.

VARIABLE-INCOME INDUSTRIES

In contrast to the foregoing types of business, there is a large group of industries which is subjected to more or less severe variations in gross income. In these industries, years of small volume may be followed by years of large volume and gratifying earnings. They may be rich or poor, princes or paupers, and may sometimes be the corporate examples of the familiar maxim: from shirt sleeves to shirt sleeves in three generations. Contributing to variable income are the following: (1) production of goods and services of the novelty and nonessential type; (2) high prices, which may add to variable demand in times of depression—e.g., automobiles, refrigerators, etc.; (3) production of heavy goods and raw materials.

In periods of depression, people naturally restrict their purchases of the nonessential items; and, conversely, in periods of prosperity, they spend large proportions of their increases in income for so-called "luxury" goods and services. In the case of higher-priced and durable consumers' goods, they are likely to be used for a longer period of time than normal when economic circumstances require. For example, it may be customary to buy a new automobile every 3 years and to replace a mechanical refrigerator every 8 or 10 years; but repurchase may readily be deferred in times of depression. Fluctuating with even greater magnitude are those businesses engaged in the production of raw materials and durable capital goods. They are the farthest removed from the consumer and suffer the effects of a pyramiding of curtailment.

Whether what has been said about variable-income industries will be true in the future, as in the past, remains to be seen. Some people may contend that cyclical influences are coming under control and that major depressions are events of the past. Certainly, the heavy and durable-goods industries enjoyed years of virtually continuous capacity operations subsequent to 1940. But this was caused by war in 1941–45, a civilian-goods replacement and housing boom in 1946–50, another war in 1950–51, and a cold war armaments race since that time.

A continuance of the housing boom throughout 1955, and a rising tide of business investment in new plant and equipment frequently took up the slack when other types of demand showed signs of faltering. *Perhaps* at long last the secret of perpetual motion—upward—for the economy has been discovered. *Perhaps* cycles not only have been moderated, but are disappearing. However, evidences of an oversold condition in numerous lines cropped up in 1951, again in 1952, as well as in 1954, 1956, and 1958. Although the total output of goods and services (the gross national product—the GNP of the economists) continued to rise steadily or just level off during the 1950's, the wide fluctuations in numerous sectors of the economy would indicate that marked variations in basic economic factors still exist.

COMPARISON OF ESSENTIAL AND NONESSENTIAL GOODS INDUSTRIES

Goods of the essential type are obviously needed regardless of prevailing business conditions; it follows that the income of concerns engaged in this field should be relatively stable. Conversely, companies producing nonessential items will experience fluctuating income to a much greater degree. It should be understood that the difference in classification between these two types of goods is largely a matter of social custom and that necessities include many things which are not absolutely essential in a physical sense. For example, among the most stable fields of enterprise are to be found both the food products and the tobacco industries. The latter may well have greater stability of income than, for example, department stores or manufacturers of wearing apparel.

COMPARISON OF LOW- AND HIGH-PRICED GOODS

High-priced goods are usually durable in character; and for this reason, their purchase by the consumer may be postponed for a considerable period of time. To illustrate, the construction of new houses virtually ceased during 1932 and 1933. Being unable to finance new homes, the public simply got along with fewer conveniences and utilized less space by the process of doubling up. Similarly, there was a deferment in the purchase of automobiles and of house furnishings during the depression period. This reaction on the part of the buying public necessarily had great effect on the income of companies operating in such fields. In great contrast, the demand for low-priced commodities tends to hold up in periods of slackened business activity, often despite the fact that some of these goods may be somewhat durable in character.

An examination of the sales record of a company such as the Armstrong Cork Company would show substantial variations from year to year. In the last 25 years, it has not been unusual for sales volume to ex-

pand or contract 50 per cent from the preceding year. The fluctuations have been accompanied by a rising trend so that, from 1935 to 1960, sales increased by 1,400 per cent. In contrast, sales of the F. W. Woolworth Company did not fluctuate more than 14 per cent from year to year; and the total increase between 1935 and 1960 was only 26.5 per cent. Although this comparison illustrates the dangers of generalization when speaking of the industrial group, it must be apparent that the synchronization of financial arrangement with the production schedule or the sales budget must be much more difficult in the Armstrong Cork Company than in the F. W. Woolworth Company. Likewise, there is need that investors and the public generally appreciate the task of management in meeting such conditions. The management of business is no simple winding of the clock, and a continuous flow of satisfactory profits is no piece of magic.

RAW MATERIALS AND DURABLE CAPITAL GOODS INDUSTRIES

Even more severe fluctuations are found in the sales records of companies engaged in the production of raw materials and capital goods. As stated previously, the result of curtailment in buying is accentuated as it proceeds from the consumer to the original source of production; and sales may fluctuate as much as 300 and 400 per cent. In the case of raw materials, this is due in part to fluctuations in prices which are so notable in commodity markets and in part to variations in the demand for end-products. The variation in sales of capital goods stems principally from the ability of industry generally to postpone purchases of durable equipment.

RELATIONSHIP BETWEEN GROSS AND NET INCOME

Throughout the foregoing analysis, the fluctuations in income have been depicted in terms of the sales record. It must be apparent, however, that these changes must also affect net income, and at an accelerated rate. This is caused by the rigidity of many forms of expense, thereby causing the differential of net income to rise more rapidly than gross income in periods of expanding business and to diminish at a faster rate in periods of recession. This may be illustrated by the following assumed statement of the gross and net earnings of the Makup Company:

Income and Expense	1960	1961
Gross income.............	$8,000,000	$10,000,000
Operating expense.........	7,000,000	8,000,000
Net income.........	$1,000,000	$ 2,000,000

It will be noted that a 25 per cent increase in the gross income caused a 100 per cent increase in the net earnings. This diversity of change be-

tween the two figures is a common feature of practical business operation and may be seen in the comparative earnings data for the Chrysler Corporation shown in Table 40. Here an earnings increase of 67 per cent between 1954–55 produced an increase in net of 525 per cent. In the 1959–60 period, a sales increase of 14 per cent moved the earnings results from a deficit of over $5,000,000 to a profit of $32,000,000.

THE PUBLIC AND THE INVESTOR LOOK AT THE PROFIT AND LOSS STATEMENT

The profit and loss statement is not only an historical report of operations, but it also serves as a criterion or measure of success. The balance sheet is a momentary flash of the financial condition at a given instant of time; it is helpful in revealing where the corporation stands, but it does not tell the investor how it arrived there. Yet, it has been the widespread practice of corporations not to provide the stockholders with detailed profit and loss statements; the information is presented to the public authorities where it can be obtained by the public, but it is seldom incorporated in the annual report. As an illustration, even so comprehensive a document as the *Annual Report* of the General Motors Corporation devotes relatively little space to the income statement.

Possibly management feels that the average investor would not understand the profit and loss statement; but, if so, this could be easily corrected by interpretation and narrative comment. Such treatment is now being given the balance sheet, and there is no real reason why it could not be extended to the earnings statement. This type of treatment, in effect, is frequently given at meetings of members of the member societies of the National Federation of Financial Analysts Societies. Managements of many companies cater to this group of investment analysts, since they influence the investment of hundreds of millions of dollars, in the aggregate.

The influence of the analyst groups has brought about the disclosure of an increasing amount of financial and corporate data. Frequently, however, this information is disclosed at meetings rather than disclosed in formal reports. A growing number of companies are issuing more informative profit and loss statements as well as balance sheets, and other financial and statistical data. However, the stockholder on the average is still not receiving the amount of information to which he is entitled. Sometimes the pretext is resorted to that publication of a complete profit and loss statement would divulge valuable information to competitors. Needless to say, they are in a position to get it from public sources, when available, as well as elsewhere.

Failure of management to provide profit and loss statements is also partly the result of the lackadaisical attitude of investors, who are content as long as they receive their dividends regularly. Little thought is

given the question as to whether they should receive more or less. At least, the trusteeship described in a previous chapter is a living trust; and the investor is not devoid of responsibility on his own part. To this end, investors, either singly or in groups, should take steps to obtain profit and loss statements and to analyze them. The following types of analyses are suggested: (1) analysis of the various phases of operations, (2) analysis of the results of operations, (3) application of the results to the investment. These analyses are given added meaning by various forms of comparison. The results of a single year's operations may have meaning in an absolute sense, but detachment and objective appraisal are possible only by comparison with other periods or with other companies.

For instance, during 1950, industrial corporations generally reported earnings running well ahead of 1949. The latter year had, in a majority of cases, been ahead of 1948, due to the industrial expansion supported by the construction and consumer durable-goods booms, while 1950 felt the effect of rearmament resulting from the Korean War. In spite of the high levels of activity, investors continued to regard the reported earnings with suspicion. The reasons are not hard to find. This country had hardly completed its transition from World War II, the pressure of accumulated shortages had only begun to be eased, and price adjustments to the new level had not been achieved with certainty when another national "emergency" hit the economy. If the country was entering upon a series of "incidents," it was obvious that a new period of economic confusion, controls, and higher taxes was upon us. As it turned out, the international situation stabilized after two or three years. Meanwhile earnings of many companies in numerous sectors of the economy increased steadily, although the earnings of some companies fluctuated more widely than others. Yet such factors only serve to make extensive and adequate analysis more vital, for the following reasons:

1. It is advantageous to know the record of a concern over a long period of time for historical purposes and to have background as perspective for current analysis.

2. Long-time analysis reflects the ability of the company to cope with fluctuating business conditions. No concern is definitely seasoned, nor has it proved its worth, until it has successfully weathered at least one major business recession and at least one depression in its own industry.

3. The progress of the company and its relationship with the industry at large may be presented more accurately. Such questions as the following may be raised and answered: "Is the company expanding normally?" and "How does its rate of growth compare with the secular trend?"

ANALYSIS WITHIN THE INCOME STATEMENT

One of the first objectives to seek from an interpretation of the income statement is an appraisal of the efficiency of operations. Two familiar

tests applicable for this purpose are the following: (1) ratio of total operating expenses to gross operating income and (2) ratios of major expense items to gross operating income. The ratio of operating expenses to operating income is familiarly known as the "operating" ratio and is one of the most convenient and over-all devices used to measure the results of operations. Those industries having a large amount of fixed capital usually have a relatively low operating ratio; and, vice versa, smaller fixed investments are accompanied by higher operating ratios.

The conclusion should not be drawn that the operating ratio is a simple and all-inclusive measure of financial soundness. As a matter of fact, it

TABLE 41
RATIOS OF WESTINGHOUSE ELECTRIC CORPORATION

Income and Expense	Percentage					
	1940	1945	1946	1950	1955	1960
Sales less discounts, etc.	100.00	100.00	100.00	100.00	100.00	100.00
Cost of goods sold	70.32	84.36	96.09	72.12	80.83	76.76
Selling, general and administrative	16.62	8.42	19.25	12.86	13.29	16.36
Profit from sales	13.06	7.22	−15.34	15.02	5.88	6.88
Other income	1.31	1.19	1.85	0.90	1.07	1.30
Total income	14.37	8.41	−13.49	15.92	6.95	8.18
Other deductions	0.83	0.33	0.16	0.08	.06	.03
Interest on funded debt	....	0.17	0.45	0.19	.83	.57
Balance	13.54	7.90	−14.10	15.65	6.06	7.58
Income taxes and surtaxes	5.61	3.47	Cr. 16.47	8.01	3.08	3.54
Provision for postwar contingencies	....	0.52	....	....	....	....
Net income	7.93	3.91	2.37	7.64	2.98	4.04

is mainly an incident of the type of industry; and this accounts for differences in the average rates shown for the three main fields of enterprise—railroads, public utilities, and industrials. On the face of things, one would be inclined to infer greater financial strength where a comparatively low operating ratio exists. However, this is usually offset by financial and fixed charges which are not included as part of the operating expenses. Thus, railroads and public utilities commonly have a larger proportion of fixed charges than the industrials. The larger amount in fixed charges results in a reduction in the proportion of gross revenues available for dividends; and, as a consequence, the percentage of gross revenues remaining for the stockholders is more nearly uniform for the three fields than might be assumed from the operating ratios. The presence of nonoperating income or expense may also greatly offset the validity of the operating ratio in certain instances, especially in the case of holding companies.

While the operating ratio may not be used as a common yardstick for interindustry use, it is a convenient index of the operating efficiency of the single unit. In brief, it shows whether or not too much of the income is being absorbed by operating expenses. At the same time, it is not sufficiently specific to permit a thorough inspection or diagnosis of the total expense account. This inspection may be made by preparing ratios to show the relation between each major expense item and gross income (sales). Among the ratios that may be used are the following: cost of goods sold to sales; selling, general, and administrative expense to sales; depreciation expense to sales; taxes to sales. Table 41, shows such ratios for the Westinghouse Electric Corporation for the years 1940, 1945, 1946, 1950, 1955, and 1960. These years are reasonably representative of the operating problems faced by manufacturing corporations. The year 1940 can be regarded as fairly normal; 1945 saw price controls dropped and many maladjustments arising out of conversion and materials problems; and 1950 was again a year of war and high-pressure production. The year 1955 was one of costly strikes. The cost problems of the company under these varying conditions are fully reflected in the various expense items, particularly in cost of goods sold and in selling, general, and administrative expense. Taxes were an important but uncontrollable variable which converted a large loss in 1946 into a profit through a refund and reduced the results in the 1950's by half.

ANALYSIS OF THE RESULTS OF OPERATIONS

As indicated above, the ultimate objective of the income statement is net income. However, the significance of net income varies according to the interests of the parties affected, as follows:

Bondholders—the amount available to cover fixed charges.
Preferred stockholders—the balance remaining after paying fixed charges.
Common stockholders—the net amount remaining after allowing for the two preceding items.

The ratio of net earnings to fixed charges is significant in revealing the position of the bondholding group. This ratio is designed to reflect, first, from the corporation's point of view, the adequacy of income to meet interest requirements as a whole; and second, from the point of view of the bondholders, the sufficiency and surety of net income to cover the net requirements of the particular issue. For high-grade bonds, the net income should seldom, if ever, be less than two times the fixed charges. At the same time, the conclusion should not be drawn that the investment rating of bonds varies directly with the income coverage of interest requirements. Again, the field of enterprise is an important factor. Railroads and public utilities commonly show less coverage than industrials because of their greater stability of income. Conversely, a higher "net income times interest" ratio is necessary for industrials to allow for their

greater subjection to income variations. And with each group, considerable variation will exist as a result of differing territories, type of operations, kind of product, and management. These variations are widest in the industrial group but are also substantial in the rails and utilities.

The foregoing point of view may also be applied to the dividends on preferred stocks. Although preferred dividends do not constitute a fixed charge in the legal sense of the word, it is necessary to have them well protected for other reasons. Inability to meet these dividends reflects upon the credit of the company and generally confuses its financial position. Ultimately, such deficiency must lead to a financial readjustment of some sort.

The net income remaining after allowing for all prior charges belongs to the common stockholder. This is of significance to stockholders in two ways: (1) the total applicable and (2) the distribution or disposal of this income. The latter phase is discussed in the following chapters, and the former may be analyzed briefly here. Because dividends payable on common stock are not a fixed obligation, the relationship between the income available for dividends and the amount paid is not as vital as net income and interest. Instead, the more accepted practice is to stress the earnings per share. Obviously, one index of the vitality of earnings is their sufficiency to cover dividends; but, in addition, much attention must be given to the trend of earnings per share over a period of time and to the relation between per share earnings and the market price of the stock.

The relationship between earnings per share and market price does not immediately concern corporate financing. It is of significance, however, because the price-earnings ratio as determined on the stock market indicates investor appraisal of the company's future. In general, the stocks of higher-grade industrial enterprises tend to sell at a greater price-earnings ratio than the stocks of companies of lesser standing. This makes it difficult to state any universal norm which may be used in interpreting the significance of the price-earnings ratio. Furthermore, this ratio varies according to the speculative moods prevalent in the markets at any given time.

In the early 1920's, a common rule of thumb was that a stock should normally be priced at 10 times earnings or 20 times dividends. The relationship between earnings and dividends was based upon the practice of paying out approximately half of earnings as dividends. However, during the speculative boom of 1928 and 1929, many price-earnings ratios were far in excess of 10:1, and most previous ideas concerning security prices and earnings had to be abandoned. During 1932 and 1933, the extreme pessimism engendered by the depression resulted in stocks selling at extremely low prices. Many stocks were quoted at prices below the net current asset values as shown on the corporation's books. This was followed in the recoveries of 1934–37 and 1942–46 by price-earnings

ratios which were again, in many cases, in excess of the old rule of 10 times earnings. But, beginning with the latter part of 1946 and into 1951, many stocks again sold at low price-earnings ratios as investors ignored the extremely high earnings reported in those years. As indicated above, the uncertainties of the future resulted in a low appraisal of current results.

However, as investors' fears were not realized, and as they grew more accustomed to recurring alarms that later subsided, they began to reappraise the steady earnings growth and prospects of many companies. Stock prices began to rise, and numerous common stocks once again sold far in excess of the 10:1 ratio. The magic "highs" of 1929 were topped by a large number of individual stocks. By 1960, the 1929 highs of the various stock "averages," which at one time had seemed to represent unattainable heights and impassable barriers, had been far exceeded. Stocks, and stock "averages" were carving out new records, which perhaps in time, might again become objectives for a new generation of investors.

SPECIFIC VERSUS OVER-ALL INTEREST COVERAGE

The foregoing analysis of the income position of a corporation tends to consider each class of securities as a whole. Actually, within each major grouping, various issues may exist, each having different claims and priority rights. For investment purposes, it is sometimes thought advantageous to differentiate between the various issues and to determine the position of each individual issue separately. This may be shown by assuming the following schedule of issues of the Makup Company:

Type of Bond	*Principal*
First-mortgage 4 per cent bonds outstanding	$1,000,000
General mortgage 5 per cent bonds outstanding	2,000,000
Debenture 6 per cent bonds outstanding	1,000,000
Preferred stock 6 per cent cumulative	1,500,000
Common stock	7,000,000

As a result of the foregoing securities, the corporation has the following charges to meet each year, in order of priority presented:

Fixed charges:	
First-mortgage bonds	$ 40,000
General mortgage bonds	100,000
Debenture bonds	60,000

Assuming earnings of $400,000 available for interest and dividends, we have the following interest coverage for the specific issues:

Type of Bond		*Times Interest Covered*
First-mortgage bonds	($400,000 ÷ $ 40,000)	10.00
General mortgage bonds	($400,000 ÷ $140,000)	2.85
Debenture bonds	($400,000 ÷ $200,000)	2.00

In computing the above ratios of "times interest covered," the interest

charges were accumulated as we moved from the senior to the junior issues. This was necessary since the first-mortgage interest must be covered before the general mortgage interest can be paid. On an over-all basis, total interest charges were covered two times. The over-all coverage will always equal the specific coverage on the lowest-ranking junior issue.

It is sometimes argued that only the over-all measurement has significance, since any failure to pay interest on the junior issue may result in a receivership; and any receivership impairs the credit rating of all issues concerned. On the other hand, there have been many receiverships in which the senior and well-protected issues have come through without loss of principal or interest, while the junior issues have suffered losses. Both approaches have their place. The over-all approach is useful for comparing one corporation with another. The specific coverage is helpful in analyzing the position of the various issues within a given company.

Some students of finance argue that the specific coverage should be computed by taking the ratio between the income available to pay interest on a particular issue and the interest requirement of that issue. In other words, the interest charges would not be cumulative. On this basis, the foregoing illustration would appear as follows:

Type of Bond		*Times Interest Covered*
First-mortgage bonds	($400,000 ÷ $ 40,000)...........	10.00
General mortgage bonds	($360,000 ÷ $100,000)...........	3.60
Debenture bonds	($260,000 ÷ $ 60,000)...........	4.33

This has the effect of showing the most junior issue as being in a somewhat better protected position than its predecessor. If the senior issue had the largest interest requirement and each succeeding junior issue had lower requirements, we would be in a position of showing greater protection as the issues declined in priority. Since it is hard to visualize a situation where a junior issue is better off than a senior issue, this method is not used in practice.

EFFECT OF SIZE UPON EARNINGS

Ask the uninitiated what relationship exists between size and earnings; and he would likely reply that the larger the firm, the larger the earnings. This reply might be due to a failure to distinguish between *amount* and *rate* of earnings, and it might arise from the greater economic stability enjoyed by large firms.

While the smaller corporations usually have smaller earnings, they may have higher *rates* of return. This does not necessarily indicate greater efficiency or profitability, although such is sometimes the case. On the contrary, the higher return may be due to undercapitalization or the type of business done. Smaller corporations will be found more frequently in

lines of activity where personal service is more important and capital investment relatively less important. As a result, reported earnings may include income that may properly be attributable to personal services. The opposite effect is obtained in the case of the small close corporation where the management comprises *all* of the stockholders. In such cases the management may adopt the policy of drawing off most of the profits through the salary account, leaving little or no net income to relate to capital investments.

While available statistics on earnings by size of business leave much to be desired, two generalizations appear safe. One is that within a given industrial classification the larger the business the larger its rate of return on capital is likely to be. The other is that the earnings of small companies are subject to wider fluctuations. As business activity moves up and down, the operating results of small companies will generally move farther up or down than will those of larger organizations. It is this characteristic which has evoked the statement that "what small business needs is good business."

QUESTIONS AND PROBLEMS

1. Discuss the importance of accounting policy as a factor in influencing the "amount" of income realized from the operation of business. Compare any two companies from the same field of enterprise, and comment on the results.
2. How does inflation affect the income and expense of industrial companies as compared with public utilities and railroads? The Trane Company, manufacturers of heating, ventilating, and air-conditioning equipment, reported the following for the years indicated:

Explanation	1950	1946	1942
Net sales	$27,632,963.00	$13,839,855.00	$9,669,720.00
Consolidated net income	2,061,072.00	1,247,322.00	528,985.00
Net income per common share	6.87	4.11	2.02
Capital investment per common share	35.96	19.60	10.53

   Obtain 1960 data for this company and evaluate the trends in the light of (*a*) influence of increased volume of sales, (*b*) effects of the increase in the price level, (*c*) efficiency of management, and (*d*) changes in product mix.
3. Consider the influence and importance of taxes in relation to income results. As an example, the following figures relating to the Budd Company may be noted:

Explanation	1950	1949
Book value per common share	$18.20	$14.57
Profit per common share	5.10	4.50
Dividend per common share	1.50	0.70
Taxes per common share	7.56	3.93

4. Do you think that annual reports should be sent to bondholders as well as stockholders? Discuss the technical difficulties of doing this.

5. In comparing net income of different companies, what are the difficulties in using the stockholders' equity as a base?
6. Comment on the variations in return on the stockholders' equity as shown in Table 39.
7. Railroads have issued new common stock in only two or three of the last twenty years. Discuss the reasons.
8. Discuss the relationship between the size of operation and income results.
9. Select a representative first-mortgage bond from each of the three major fields, and compare them as to the "times interest earned."

REFERENCES

BUCHANAN, N. S. *The Economics of Corporate Enterprise*, chap. viii. New York: Henry Holt & Co., Inc., 1940.

BURTCHETT, FLOYD, and HICKS, CLIFFORD M. *Corporation Finance*, chap. xxv. 3d. ed. Lincoln, Nebraska: Johnsen Publishing Co., 1959.

CRUM, W. L. *Corporate Size and Earning Power*. Cambridge: Harvard University Press, 1939.

DOWRIE, G. W., and FULLER, D. R. *Investments*, chap. xx. Rev. ed. New York: John Wiley & Sons, Inc., 1961.

GERTENBERG, CHARLES W. *Financial Organization and Management*, chap. xvii. 4th ed. Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1959.

GUTHMANN, H. G. and DOUGALL, H. E. *Corporate Financial Policy*, chap. 23. New York: Prentice-Hall, Inc., 1955.

MCCONNELL, JOSEPH L. "Corporate Earnings by Size of Firm," *Survey of Current Business*, May, 1945, pp. 6–12.

PLUM, LESTER V., HUMPHREY, JOSEPH N., JR., and BOWYER, JOHN W., JR. *Investment Analysis and Management*, chap. 10. Rev. ed. Homewood, Ill.: Richard D. Irwin, Inc., 1961.

Chapter 23 ►

EXECUTIVES AND THEIR COMPENSATION

THE DISTRIBUTION of the income which the corporation has been able to realize from its activities may now engage our attention. Although operating expenses consume by far the largest portion of total income, they generally involve few problems of basic corporate policy. Consequently, they are left largely to the discretion of administrative management. For these reasons, our analysis will be limited to those phases of the income account which require approval by the board of directors—compensation of executives, dividends, and earnings retained in the business. These items of income diversion relate mainly to net income. It is true that executive compensation is considered to be an operating expense; but at the same time, its determination, particularly with respect to the upper echelon of executives, is often influenced by net income. The questions relating to executive compensation will be treated in this chapter, following which attention will be given, respectively, to dividends and retention of earnings in the business.

The tremendous growth in industry since World War II has brought with it a maze of complicated business, economic, and engineering problems. The solution of these problems as well as planning for the future has placed a much higher premium on executive skills than formerly was the situation. Furthermore, the sheer size of many business and economic units, as well as the multitude of problems pressing for solution has necessitated an increased number of persons with executive skills and decision-making powers per company than formerly sufficed. The competition for this type of person has steadily increased. Management literature in increasing volume and growing detail has told of this search and of the various efforts and programs to evaluate skills and develop sound, attractive compensation plans and promotion programs. One and all stress the deleterious effect taxation has on current compensation. They describe as well the numerous deferred and contingent pay plans which

have been developed out of the search to attract and hold management talent, particularly in the upper and top echelons.[1]

PURPOSE OF EXECUTIVE COMPENSATION

Ideally, of course, executive compensation is intended to obtain ability and reward results. In a broad way, this is accomplished; but many qualifications should be made, despite the intense efforts of many companies to attract and hold executives. For compensation to be related directly to ability and results, it is necessary for executive employment to be contracted on essentially an arms-length bargaining basis. In many of the areas of the middle and next-to-top management levels this is often the case. It is also true in the initial placement of top executives. One can only generalize on these situations. In some industries competition for executives at all levels is keen. The owners of the company must be diligent in seeking and rewarding its executives. In still other areas only the top management executives are in demand. In these cases the matter of arm's-length bargaining is not always the case. In the past, before the "new era" in management "care and feeding," it distinctly was not always the case. We will review some of these situations subsequently. That they were brought to public attention and criticism is probably one reason why such cases are not so prevalent today.

Usually, the top executives are members of the board of directors and, in effect, set their own salaries, limited only by their judgment, the practice in the industry, and an occasional stockholder's action. Only in the concerns having so-called "incentive plans" is the executive's compensation geared in any direct way to results. Moreover, the incentive plans represent a one-way gearing, i.e., bonuses in years of good earnings and no penalty in years of poor earnings.

COMPARISON OF OFFICER AND OWNER RETURNS

Rule-of-thumb standards are, of course, inadequate to determine the most desirable distribution of corporate income. As a basic principle, most observers would likely agree that the division should synchronize as nearly as possible with the contributions to the total output. However, measurement of individual contributions is impossible; and top execu-

---

[1] Robert B. Fetter and Donald C. Johnson, *Compensation and Incentives for Industrial Executives* (Bloomington: Indiana University Press, 1952). *Compensation of Management Personnel* (Chicago and London: The Dartnell Corporation, 1952). See also "Problems in Executive Salary Determination," *Management Record*, National Industrial Conference Board, Vol. XVII, No. 1 (January, 1955), pp. 9–11. Also, "Incentive Bonus for Executives," *Management Record*, Vol. XVIII, No. 3 (March, 1956), pp. 82–84, 102–5. H. Fox, "Current Stock Option Plans," *Management Record*, Vol. XXI, No. 9 (Sept., 1959), pp. 270–73.

tive salary schedules are usually fixed through individual bargaining or friendly negotiation with those in control. Remotely, the responsibility may be placed on the stockholders because of their right to elect directors; but there is little effective exercise of this power, for reasons already discussed. In addition, the stockholders are usually contented so long as they receive a fair return on their investment.

Another factor which complicates appraisal of the division of income between executives and owners is the difficulty of drawing a distinct line between an executive and certain other employees, particularly where the latter are on a salary basis. Bonus plans vary greatly in the number of officials scheduled to receive a share in the extra compensation. Sometimes, only a handful of top officials share in any bonus distribution. Other corporations may make the incentive distribution quite general in an effort to reach all salaried employees having any latitude for judgment.

It is obviously impossible to devise any yardstick which would determine whether or not there is an equitable distribution of income between the owners and the executive group. At the same time, there are many questions of philosophy or of underlying principle which arise solely on the basis of capitalistic operation. There is no market in the true sense of the term for top executives, and their placement is mainly a matter of private negotiation. Under these circumstances, high officials are frequently in a position to demand the top price. They may not be criticized for this because it is in keeping with our standards of human conduct. It is expected that each individual should normally look out for his own interests because no one else will assume the responsibility.

Seemingly, stockholders would act in a similar manner in the situations that require it; but there are many restrictions in the corporate system which prevent vigorous or prompt action on their part. Acting through a legal process of delegated authority, they can, at best, move slowly to protect their interests. As a result, the capitalistic system has developed so that there may be great reward for those having heavy responsibility with little risk; whereas the owners, with little direct responsibility, have minimum or restricted income return in the face of residual risk. Possibly this condition is in keeping with the long-term trends, which show surprising shrinkage of the return on capital; but stockholders, for their own protection, need to apprise themselves of this development. At least, the salaries of executives are now a matter of public record; and the failure of stockholders to respond must be considered to be evidence of implied sanction.

If we examine the data for 1957–58, the following comparisons can be made:[2]

[2] Computed from summary data in Internal Revenue Service, *Statistics of Income for 1957–58, Preliminary Report, Corporations.*

Explanation	Percentage of Net Income before Compensation of Officers and before Federal Income Taxes		
	Manufacturing	Transportation and Public Utilities	Trade
Compensation of officers	14	9	45
Dividends paid	28	51	12
Federal income taxes	44	57	28

Although no single year can furnish a satisfactory basis for generalization, the data above indicate what can be expected under conditions of war-induced activity and high taxes. It must be admitted that these conditions may be more nearly normal than exceptional.

The foregoing percentages on officers' compensation show clearly that it represents an important item of expense in the operation of a business. They also show some of the marked differences existing between manufacturing, public-utility, and trade corporations. Part of these differences is probably a matter of what is customary in the particular group. For instance, public utilities customarily pay comparatively low salaries, possibly as a reflection of the relative stability characteristic of that group, as well as the regulated status of the business. The varying size of corporations included in each group shows up in the retail group, where officer compensation appears much larger and taxes smaller. Small corporations are more numerous in this group, and owner-management is more prevalent. As a result, officer compensation is probably a less refined concept and includes more of a mixture of salaries and profits paid out as salaries. Likewise, the lower percentage in taxes is partly due to the fact that small companies enjoy somewhat lower taxes. Another reason for the lower tax figure is the fact that much more of the net income before taxes is paid out as compensation and, hence, is deductible for corporate tax purposes.

Passing judgment on the reasonableness of salaries is probably impossible on a generalized basis; but, at the same time, it is easy to pose numerous questions which reflect the lack of any standards. Thus, it is difficult to understand why the Bethlehem Steel Corporation for many years paid larger executive compensation than its much larger competitor, the U.S. Steel Corporation. Or, why should smaller companies sometimes feel compelled to pay salaries in excess of that paid to the president of the American Telephone and Telegraph Company? These are inconsistencies within the circle of private industry itself which, in all fairness, should be explained to the stockholders, who are the real owners of the corporation. Large salaries have been attacked by various social "reformers" for the purpose of creating public unrest, but our concern here is only with financial merit and the most economical conduct of business operations.

These salary schedules now have the benefit of publicity and may be more readily justified than when they were paid without proper reporting to the stockholders. Certainly, abuse is less likely than under conditions of secrecy.

RELATIONSHIP BETWEEN SALARY SCHEDULES AND SIZE OF COMPANY

At various points, it has been shown that the size of operation has had a distinct effect upon the characteristics of business operation. Salaries and their relationship to income are no exception. As a general rule, the larger companies pay larger salaries in absolute amounts, but those salaries represent smaller proportions of sales or earnings than is true of small companies.

The size factor may be illustrated by a study of compensation practices in 664 corporations made in 1949 which showed the following relationship between executive compensation and company size, based on profits:[3]

Company Profit Classification	*Percentage of Profit Absorbed by Executive Compensation*
Under $500,000	57.0
$500,000–$2,000,000	26.9
$2,000,000–$7,000,000	9.5
$7,000,000–$15,000,000	5.2
Over $15,000,000	2.7

While none of the companies included was truly small, it is evident that the larger the company, the greater the advantage in terms of cost of executive services.

Two additional studies related to executive compensation published in 1952 and 1953, tend to indicate a continuation of certain trends noted above, particularly as they relate to percentage of profits absorbed by executive compensation. On the other hand these studies, as do others, note certain structural changes in the methods of compensating executives.

One of the later studies analyzed the compensation paid to the three highest officials of ninety-one companies with employed capital of $10,000,000 and over, in the prewar period 1929–38, and in the postwar period 1945–49.[4] The essence of the study is that postwar compensation ratios are lower than the prewar figures, and the larger the company the larger the differential. The lower ratios of recent years reflect in part

[3] Arch Patton, "Current Practices in Executive Compensation," *Harvard Business Review*, Vol. XXIX, No. 1 (January, 1951), p. 62.

[4] O. W. Blackett, *Management Compensation* (Michigan Business Studies, Vol. XI, No. 2) (Ann Arbor: University of Michigan Press, April, 1953).

the higher earnings of these years. The author, however, found no evidence that the improvement in earnings was greater for the larger than for the smaller company in his sample. Consequently, he stated, there was no choice but to regard the differential change in compensation ratios between large and small companies as evidence of structural changes in methods of paying the chief executives of industrial companies.

The Dartnell survey of management compensation already referred to covers a broader field than the Blackett study.[5] Its gist and scope may be summed up in its introduction: "A Dartnell survey of executive salary ranges with supplementary pay plans used by 2,100 companies to combat high taxes and inflation." The study noted that for the first time (1952) in the history of the United States a good salary had lost much of its incentive value in compensating men responsible for business profits—the top and middle management group. The study bears heavily on the fact already noted—the development by companies of a wide variety of what might be called management interest incentive plans. Most of these plans have as their common denominator the avoidance of restrictive and excessive current taxation—taxation which lays its heaviest incidence on current income. A point indicated by both studies, and which is familiar to all students of this problem, is that relatively the lower executive groups are gaining proportionately more than the highest paid executive. This is part of the processs of "leveling-up" (or perhaps, "leveling-down") which has been under way in the entire economy in the past two decades. The problem of business owners, whether a small or large group of stockholders, is that this process on the one hand does not "level-off" managerial ability, or on the other hand, force them to raise the chief executive or executives to a rate of emolument beyond reasonable proportions (or that the income of the enterprise can adequately absorb) and leave a fair amount of compensation for the owners.

Not only do the salaries of executives in small companies seem more important in relation to sales and earnings, but there is also a marked difference in their duties. The executive in the big business is usually an executive in fact. He develops policy, and he makes policy decisions. Details are ordinarily carried out at a lower level, and special staffs carry on much of the analytical work. In the smaller business, the "executive" often finds it difficult to find the time needed for thoughtful analysis in order to develop policies and carry them out. Much of the daily detail comes to him for decision, and there is little in the way of staff to carry on the "pick-and-shovel" work so necessary in analyzing results or developing new activities. In the truly small corporation, the "executive" may be a production man in the shop or a salesman on the floor, as well as performing the functions of the controller and treasurer.

---

[5] See footnote 1.

QUALITATIVE ASPECTS OF EXECUTIVE COMPENSATION

The most significant criteria of executive salaries are not, however, found in their quantitative relationship to net income, dividends, and the various items of expense. These comparisons do afford a degree of objectivity, but the reasonableness of compensation to executives will always be judged on a qualitative or subjective basis. The public generally realizes that compensation should vary with the amount of responsibility assumed, and there has seldom been any great outcry against salaries simply because they were large. The thought as to whether or not the compensation was fair has been much more predominant in public thinking.

In the appraisal of responsibility, the distinction between policy making and administrative direction, on the one hand, and technical performance, on the other hand, has been generally recognized. Most people believe that capable leadership is essential to successful operation and are willing to pay a price to attract the right kind of talent. Viewed in this light, it is important to distinguish between the operating and the financial life of a business unit. Obviously, financial results depend upon satisfactory operations; but it is equally true that successful operations are dependent upon sound financial policy. As a result, a careful distinction must be made between technical efficiency in the engineering sense and financial achievement in the profit and loss and income sense. Many ideas which would appeal to the engineer, with his interest in technical performance and conservation of energy, may prove too expensive to use when evaluated from the point of view of financing the project and earning a reasonable return. For example, electric locomotion offers many advantages over steam; but its cost is frequently too great to warrant its use. Production of synthetic gasoline is technically feasible; but the cost of production is still too high to make it economically possible except under the stress of war-time, when financial expediency steps aside in favor of military necessity.

One may be prone, therefore, to condemn financial policy as a limiting force upon the progress of civilization. On the contrary, it is intended to serve as a safety valve and to insure production at the lowest possible cost. It is true that, at times, the search for the lowest cost may result in what appears to be a rather nearsighted policy such as is evidenced in the waste of our natural resources; but it would be difficult to say that the future may not bring forth some method of production which would recover the apparent waste or introduce substitutes that would make existing products obsolete.

Much responsibility is placed upon individuals who are called upon to make decisions along these lines, and one of the real problems of society is to find talent of sufficient capacity to do the job. It is a question not of getting men with technical skill but of getting men with executive leadership—men with constructive ideas who put progress above the

status quo. "The capable executive is the man who has ideas, who inspires others to help effectuate them, who is able to co-ordinate the work of his subordinates. A few outstanding ideas often mean the difference between the signal success of an enterprise, and mediocrity or even failure."[6]

It is a common complaint that first-class executives are scarce. Even in the worst days of the last depression, there was difficulty in filling the top jobs. College students may not easily appreciate this condition because many look forward to the day when they will be in positions of authority. But leaders are chosen and are not self-appointed. The observation that "power with people is more important than power over people" illustrates the type of leadership which is sought. To achieve this quality, long years of training and experience are usually necessary. Beyond this, there are numerous prerequisites which are not easily cultivated by training, such as character and personality.

MEANS OF ATTRACTING EXECUTIVE TALENT

The shortage of executive talent has led to various ways and means to increase the incentive of the executive or official heads of the corporate family. Although salaries frequently appear large enough to stimulate the maximum efforts of the favored recipients, they are open to the objection

TABLE 42

TOTAL COMPENSATIONS PAID THE PRESIDENTS OF SELECTED CORPORATIONS, 1929, 1934, 1955, AND 1959

Corporation	1929	1934	1955	1959
Bethlehem Steel Corporation...	$1,635,753	$180,000	$583,270	$407,785
Columbia Gas System, Inc.....	251,335	91,300	95,000	113,333
Corn Products Refining Co.....	275,096	144,750	80,000	151,900
Coty, Inc....................	323,303	46,710	71,956	47,350
International Harvester Co.....	259,703	60,757	211,865	198,709
Jones & Laughlin Steel Corp...	359,151	250,000	163,351	190,000

that they are not based upon results. Hence, many industrial leaders contend that the key men should share according to the fruits of the enterprise. This is usually accomplished by the payment of a bonus when earnings exceed an established minimum standard. It is common to establish a fixed salary, with the bonus to be paid in addition. The results may be seen in the sample of presidential compensation shown in Table 42.

The variations between the lush "new-era" year (1929), depression (1934), and postwar years (1955 and 1959), are striking, as are the actual levels of compensation paid in all four years. The amounts paid in 1934

[6] Temporary National Economic Committee, *Bureaucracy and Trusteeship in Large Corporations* (Monograph No. 11 [Washington, D.C.: U.S. Government Printing Office, 1940]), p. 85. See chap. viii, "Personal Factors," for a discussion of business leadership.

may be surprising in view of economic conditions prevailing at that time; but still, it must be recognized that all the cases shown represent substantial reductions from 1929. Neither the compensation paid in 1955 nor that paid even in 1959 returned to 1929 levels, in part because of a change in corporate compensation policies as we have seen and in part because of personnel changes. Top executives represent peculiar zones of influence and individual bargaining. The high compensation—salary and bonus—paid one man will not necessarily be paid his successor. In fact, the more outstanding the amount, the less likely it is to be continued upon a change in administration.

Some authorities believe that real leadership cannot be bought and that it is the result of an appeal to incentives other than financial return. There is a feeling that bonuses are unnecessary and that they may favor the self-seeking individual who places personal gain above the welfare of the corporate group. The following comments by executives illustrate this point of view:

> Enormous executive bonuses are utterly inexcusable. They were the "growing pains" of industry. They were paid at a time when everyone was trying to take all he could while the taking was good.
>
> Bonuses are indefensible. Profits are not a reflection of managerial ability to any considerable extent; they are due to general conditions—high during prosperity and low during depression. But men have to work harder during the periods of depression.[7]

Little is to be gained by entering into a long debate about the merits of the bonus system, but it should be recognized that some form of bonus payment is a common feature of business operation. It is used as a means of compensating both the operating personnel and the executives. The concern here is only with the latter group, because of their responsibility to the stockholders. The owners of the typical corporation commit their enterprise to a small group, and it is fitting that they be informed about the actions of their managers. It is with this stockholder interest in mind that the various types of bonus plans will now be discussed.

CASH BONUS

The principle underlying the cash bonus is that the added compensation is paid in consideration of, or as a reward for, greater earnings obtained during a fiscal period. Managerial services are regarded as being of a current nature, and the obligation is settled immediately through sharing a portion of the company's cash with the management. While seeming to rest on a *quid pro quo* basis, the cash settlement may give undue emphasis to possible fortuitous events over which management has no control and no responsibility. For instance, in the late 1920's and again in the 1940–50's, many corporations enjoyed exceptional earnings which

[7] *Ibid.*, p. 91.

were not necessarily a reflection of managerial ability but merely a result of the large volume of business common to most fields of activity. It may be said with some reason that these exceptional earnings arose in spite of, rather than because of, management, Nevertheless, the cash bonus has the advantage of being specific and, unlike the stock bonus, free from possible entangling speculative motives.

In recent years, the use of cash bonuses has become quite widespread and has been extended down to production personnel in many cases. This was done, in part, to provide an incentive system. An additional and important motive is the desire to avoid establishing salary precedents. Salaries are set at levels that can be maintained under reasonably normal circumstances, whereas the bonus is used to establish a higher compensation level which fluctuates with the ability of the corporation to pay. Of course, the cash bonus when sufficiently high is subject to the erosion of progressively higher taxes.

CALCULATION OF THE BONUS

The bonus should be computed in relation to net income in preference to gross income. If it were based upon the latter, it is obvious that too little incentive would exist to bring expense items under control. Executives would be free to incur added sales expenses in order to obtain greater gross income, and the stockholders would be saddled with the disproportionately higher expense. Moreover, it appears equitable to require that a fair return be made on the investment before granting the bonus. This may be done by establishing either a flat minimum figure or by expressing the minimum as a stated percentage of the investment. Illustrative of the former, the Bethlehem Steel Corporation plan (in force from 1917 to 1931) provided for a bonus when net earnings exceeded $2,000,000 (after fixed charges but before depreciation). In the case of the United States Steel Corporation, bonus payments did not begin unless net earnings were in excess of $100,000,000. It should be noted, however, that the basic salary scale of the latter corporation was much more generous than the former. Under the General Motors Corporation system, no bonus allowance is made until 5 per cent is earned on the capital invested.

AMERICAN TOBACCO COMPANY

The bonus plan of the American Tobacco Company which originated in 1912 is one of the oldest bonus plans and affords an interesting example of the way such plans have changed with changing standards of officer responsibility. The plan was first authorized by a bylaw (Article XII) which provided that

> As soon as practicable after the end of year 1912 and of each year of the Company's operations thereafter, the Treasurer of the Company shall ascertain

the net profits, as hereinafter defined, earned by the Company during such year, and if such net profits exceed the sum of $8,222,245.82, which is the estimated amount of such net profits earned during the year of 1910 by the businesses that now belong to the Company, the Treasurer shall pay an amount equal in the aggregate to ten per cent of such excess to the President and five Vice-Presidents of the company in the following proportions, to wit: One-fourth thereof, or 2½ per cent of such amount, to the President; one-fifth of the remainder thereof, or 1½ per cent of such amount, to each of the five Vice-Presidents as salary for the year, in addition to the fixed salary of each of said officers.

Since the net earnings for the period from 1929 to 1933, inclusive, averaged $36,000,000, it is evident that a good-sized melon was available for distribution to the six officers. In addition, the directors had provided a plan in 1929 for certain valuable stock rights in favor of the management; it has been estimated that the value of the rights to the president alone amounted to $705,550 in 1929 and $1,169,280 in 1931.[8] In the latter year, a complaining stockholder instituted legal proceedings against both the stock rights and the bonus payments. Action on the stock rights was disallowed on the grounds that it was outside the jurisdiction of the federal courts. The plaintiff was unsuccessful in his plea against the unreasonableness of the bonus payments before the Circuit Court of Appeals, but the Supreme Court of the United States reversed the decision and remanded the case to the District Court for further proceedings.

Following the reversion to the District Court, an agreement was reached out of court which changed the terms of the bonus.[9] In 1933, the officers were granted a bonus of 10 per cent of the earnings in excess of $13,000,000 (as compared with $8,222,245.82 under the original agreement). In 1934, they were to receive 10 per cent of the excess over $14,-250,000; and in 1935 and subsequent years, they were to receive 10 per cent of the excess over $15,500,000 and up to $32,500,000. From $32,500,-000 to $35,000,000, a 9 per cent bonus was granted; from $35,000,000 to $37,500,000, 8 per cent; from $37,500,000 to $40,000,000, 7 per cent; from $40,000,000 to $42,500,000, 6 per cent; and 5 per cent of all income in excess of $42,500,000. This plan continued in effect until 1949, when it was modified substantially. Under an agreement approved on April 6, 1949, the amount to be distributed to the president and five vice-presidents was reduced to 5 per cent of the income in excess of $15,500,000. This was to be distributed 1¼ per cent to the president and ¾ per cent to each vice-president. The change had the effect of reducing the compensation of these officers by approximately one half.

---

[8] George T. Washington, "The Corporation Executive's Living Wage," *Harvard Law Review*, Vol. LIV, No. 5 (March, 1941), pp. 733, 743.

[9] Several years later, the sordid background of the settlement came to light. In proceedings that finally resulted in the disbarment of the attorney of the tobacco company, it was shown that the complaining stockholder had been paid more than $500,000. Moreover, the funds came from the treasury of the company. See *ibid.*, p. 745.

Still later a further reduction was made in the rate of compensation of these principal officers. On April 4, 1951, the stockholders approved a program which amounted to a reduction of $144,000 or about 53 per cent of what would have been payable to the president under the previous plan. The vice-presidents each had a reduction of about $75,000, or 41 per cent of what would have been their 1950 compensation. The plan, in brief, provided that subsequent to 1952, a portion of all net income in excess of $15,500,000 a year should be apportioned to a compensation fund as follows: 5 per cent of the first $6,000,000; 4 per cent of the next $2,700,000; 3 per cent of the next $2,700,000; and 1 per cent of the balance. The fund would be divided 20 per cent to the president and 16 per cent to each of five vice-presidents.

A further modification of this plan was approved in 1957. The bonus was, thereafter, based on 5 per cent of the first $6,000,000 of net earnings in excess of $15,500,000; 4 per cent of the next $2,700,000; 3 per cent of the next $2,700,000; 2 per cent of the next $2,700,000; and 1 per cent of the balance of net earnings. The amount so determined was to be distributed 20 per cent to the president, 16 per cent to each of two senior vice-presidents, and the balance to other officers and key employees. This action increased the amount available for distribution slightly, widened the number of eligible persons, and made important changes in the method of distribution. In effect, the plan became a combined incentive and retirement program. The amounts computed by the formula are allocated to executives receiving over $30,000 per year (other than the president and two senior vice-presidents) with 50 per cent pro rata based on salary received and 50 per cent on the judgment of the incentive committee. The various allocations are then distributed 50 per cent in cash and 50 per cent during the 10 years following retirement. The participants must remain with the company for at least 5 years (unless retired earlier or released by the incentive committee); they must be available for consultation during retirement; and they must not work for competitors.

STOCK BONUS

When stock is paid as a bonus, it is apparent that a longer-term view is placed upon management. A permanent investment is given to the executive in preference to an immediate cash settlement. In most cases, the recipient is free to sell his shares; but this simply transfers the investment equity to some other party. As far as the corporation is concerned, there is no immediate drain upon the cash account, although the ultimate and potential demands are increased because of the heavier dividend requirements. It is anticipated that the status as a stockholder which is given to management will result in an improvement of earning power to provide the funds necessary to meet this need. Unfortunately, phenomena over which management has no control frequently arise to prevent the realiza-

tion of this simple formula. The depression of the 1930's would be a case in point. In addition, it should be recognized that often the dividend returns of the leading officers may be relatively small in comparison with the basic salary.

COMBINATION OF CASH AND STOCK BONUS

The settlement of a bonus obligation by a combination of cash and stock is intended to serve both as a reward for past performance and as a stimulus for future effort. There is an implied approbation of the current earnings record, with the stock serving as an inducement for further achievement. The bonus plan formerly used by the United States Steel Corporation is illustrative of this arrangement. An impartial committee had the power to pay the bonus entirely in cash or partly in cash with the balance in common or preferred stock. Stressing the desirability of permanent management, the committee could withhold the stock for a period of five years. If an executive was discharged or left for other reasons during the interim, the stock might be forfeited. Distributions were 60 per cent in cash and the balance invested in the common stock which was held in the name and interest of the beneficiaries. The stock reverted to the company in the event that the beneficiary left within five years after the distribution for any reason whatsoever. The plan was established in 1921 and canceled in 1935. Today, the company has a straight stock option plan currently covering nearly 300 key employees. The General Motors plan discussed next is probably the most comprehensive cash and stock bonus plan in effect today.

GENERAL MOTORS CORPORATION PLAN

The General Motors Corporation provides a pension plan for hourly-rate employees in accordance with union agreements and a retirement program for salaried employees. In addition, it has a cash and stock bonus plan which is restricted to the management group which in recent years has included from 12,000 to 14,000 employees. It also has a restricted stock option plan which is limited to a small executive group but is integrated with the larger and older bonus system. In common with all bonus plans, the announced purpose is to vitalize the incentive of those responsible for the success of the company. To quote from a letter addressed to the stockholders: "The safeguard to the capital of the stockholders invested in the business of General Motors Corporation, as well as the earnings power of that capital, is absolutely dependent upon the intelligence and aggressiveness with which the organization deals with the very important problems that constantly arise."

The plan originally provided that 10 per cent of the net profits in excess of 7 per cent on the invested capital were to be allocated to the ex-

ecutive group. The sum thus allocated was to be distributed part in cash and part in stock. In 1946, the company did not earn the required 7 per cent, and no bonuses were declared. Early in 1947, the plan was amended to reduce the required earnings on capital to 5 per cent and increase the bonus set aside to 12 per cent of the amount remaining. Since 1947, bonuses have been paid in every year and on varying terms.

The plan is administered by a Bonus and Salary Committee which has the power to set the minimum salary determining eligibility and the proportions of cash and stock to be awarded. The committee has authority, however, to make awards in exceptional cases to individuals receiving less than the established minimum.

In the years 1951–60, the amounts available for distribution under the formula fluctuated between $52 million and $95 million. In 1961, the amount was $93,038,881. Of this sum, $4,575,563 was set aside for payment to employees of foreign subsidiaries and the balance distributed among 13,995 employees receiving annual salaries of $9,000 or more. The distribution was made approximately equally between cash and stock. Awards in excess of $1,000 were paid over a two- to five-year period. Under $1,000 they were paid in full in cash.

In 1957, the company established a stock option plan for key executives. The action appropriated 4,000,000 shares for use in 1957–62, with the proviso that not more than 75,000 shares could be granted to any one employee. The options are priced at 100 per cent of the market price on the date granted and are effective from 18 months after issuing date. They expire 10 years from issuance unless the employee retires or dies at an earlier date. The options are restricted options as discussed below but are related to the basic bonus plan.

Executives eligible for stock options do not receive their bonus awards on the current 50–50 basis. Instead, in 1960, they received 75 per cent of their awards, as determined by the committee, in cash. The other 25 per cent became a contingent credit which could be drawn upon whenever the options are exercised. The amount of stock authorized under the option is for three times the amount of stock provided by the executive's contingent credits. The "75 per cent in cash" bonus is spread over the succeeding 5 years of employment. In 1960, 261 executives participated in this phase of the plan.

LEGALITY OF BONUS PAYMENTS

In considering the legality of bonus distribution to executives, the chief emphasis is necessarily placed upon the respective rights of the parties involved. Do the directors have the right to stipulate large salaries without limit? Do the directors have the right to establish a bonus system for the benefit of the executive officials? As is true of most legal issues, no general answers may be reached on these questions; but perhaps certain principles do become established by the individual cases.

Usually, most bonus plans are approved by formal vote of the stockholders. Some particular individual or committee may be given the power to work out the percentages of distribution, but it is customary to seek the consent of the stockholders as to the general principle of excess distribution. After all, net earnings belong peculiarly to the owners, the stockholders; and it would be necessary to obtain their sanction before any share of the same may be diverted to channels outside the corporation. Assuming that this is done, there still remains the matter of the rights of the dissenting or minority stockholders.

Both the American Tobacco Company and the Bethlehem Steel Corporation have had to contend with suits instituted on the basis that the returns of certain executives were excessive. Complaint was registered that the stockholders were deprived of their just share of income distribution. In addition, the stockholders possess the right to demand of their officers a proper accounting for funds, although, at the same time, they must substantiate their action with the necessary evidence of justification. If the latter is lacking, the court may dismiss the case, as was true of the Bethlehem Steel Corporation incident. If the merits of the case are established, the following principles would appear to be applicable:

1. The stockholders have a right to establish a bylaw or make provisions for a bonus system.

2. At the same time, these provisions may not be "used to justify payments so large as in substance and effect to amount to spoilation or waste of cooperative property."[10]

3. Standards of the reasonableness of compensation are lacking, and the courts are compelled to look more to the *abuse* of power than to the *existence* of power by the directors to fix remuneration. Large compensation, in itself, affords practically no basis for action.

The position of the courts is indicated by the following extract taken from the decision of the judge in the case of *McQuillen* v. *National Cash Register Company:*

> It may be conceded that, prima facie, judged by appropriate standards of the worth of the services of any individual for any particular executive position, a salary of $100,000 a year appears to the average person, of average business experience and responsibilities, to be more than liberal compensation. However, courts are not permitted to be controlled by this test any more than by what the average judge, familiar with cases of the present kind, might himself conclude to be adequate compensation. We must distinguish between compensation that is actually wasteful and that which is merely excessive. The former is unlawful, the latter is not. The former is the result of a failure to relate the amount of compensation to the needs of the particular situation by any recognized business practices, honestly, even though unwisely adopted—namely, the result of bad faith, or of a total neglect of or indifference to such practices. Excessive compensation results from poor judgment, not necessarily anything else. If the rule were otherwise, the result would be destruction of autonomy in private enterprise to a degree that would render such enterprise

[10] See the ruling of the Supreme Court, *Commercial and Financial Chronicle*, June 3, 1933, p. 3818.

no longer private; personal initiative and its just rewards would disappear, and this would undermine the very basis upon which our economic life, with its constitutional guaranties, is founded, and upon which our democratic form of government depends.[11]

THE TAX PROBLEM

The problem of executive compensation has been complicated in recent years by the high level to which income tax rates have been pushed. It is difficult to provide a compensation incentive to executives when the added income is subject to increasing rates such as are shown in Table 43.

TABLE 43

COMBINED NORMAL TAX AND SURTAX*

If the Surtax Net Income Is—	*The Tax Is—*
Not over $2,000	20.0% of the surtax net income
Over $ 2,000 but not over $ 4,000	$ 400 plus 22% of excess over $ 2,000
Over 4,000 but not over 6,000	840 plus 26 of excess over 4,000
Over 6,000 but not over 8,000	1,360 plus 30 of excess over 6,000
Over $ 8,000 but not over $ 10,000	$ 1,960 plus 34% of excess over $ 8,000
Over 10,000 but not over 12,000	2,640 plus 38 of excess over 10,000
Over 12,000 but not over 14,000	3,400 plus 43 of excess over 12,000
Over 14,000 but not over 16,000	4,260 plus 47 of excess over 14,000
Over $ 16,000 but not over $ 18,000	$ 5,200 plus 50% of excess over $ 16,000
Over 18,000 but not over 20,000	6,200 plus 53 of excess over 18,000
Over 20,000 but not over 22,000	7,260 plus 56 of excess over 20,000
Over 22,000 but not over 26,000	8,380 plus 59 of excess over 22,000
Over $ 26,000 but not over $ 32,000	$ 10,740 plus 62% of excess over $ 26,000
Over 32,000 but not over 38,000	14,460 plus 65 of excess over 32,000
Over 38,000 but not over 44,000	18,360 plus 69 of excess over 38,000
Over 44,000 but not over 50,000	22,500 plus 72 of excess over 44,000
Over $ 50,000 but not over $ 60,000	$ 26,820 plus 75% of excess over $ 50,000
Over 60,000 but not over 70,000	34,320 plus 78 of excess over 60,000
Over 70,000 but not over 80,000	42,120 plus 81 of excess over 70,000
Over 80,000 but not over 90,000	50,220 plus 84 of excess over 80,000
Over $ 90,000 but not over $100,000	$ 58,620 plus 87% of excess over $ 90,000
Over 100,000 but not over 150,000	67,320 plus 89 of excess over 100,000
Over 150,000 but not over 200,000	111,820 plus 90 of excess over 150,000
Over 200,000	156,820 plus 91 of excess over 200,000

* Rates re-enacted in Revenue Act of 1954 applying to taxable years beginning after January 1, 1954.

For years it has been more or less customary to think of executive-level salaries as beginning at about $10,000. Yet, at this point, the executive with two dependents will pay about $1,460 in federal income taxes plus possible state income taxes. If his salary advances 50 per cent to $15,000 per year, his tax will nearly double to $2,900. Table 44 (p. 463) shows the federal income tax for 1960 computed for these and other income levels. Although it is true that part of each additional dollar accrues

[11] 27 Fed. Supp. 639, 653.

to the benefit of the taxpayer, it is also true that, as each added dollar is subjected to higher taxes, it affords less incentive to the recipient.

Nor do the various stock bonus arrangements described above afford much relief. Stock given to executives or sold on options at a significant amount below market value gives rise to taxable income under present income tax regulations. The value of the donated stock or the difference between market value and the price paid by the executive must be taken

TABLE 44

FEDERAL INCOME TAX PAYABLE IN 1960 BY A MARRIED MAN WITH TWO DEPENDENTS*

(After Allowance for Personal Exemption)

Salary	*Federal Income Tax*
$ 5,000	$ 520
10,000	1,460
15,000	2,900
25,000	6,268
50,000	18,884
80,000	37,824
100,000	51,480

* Computed at rates in effect on January 1, 1961.

into his income for the year in which the transaction occurs. Any subsequent increase in the value of the stock will be taxed as a capital gain when and if one is realized. This means that stock bonus arrangements afford relief from the tax problem only in the upswing of securities prices. From the viewpoint of long-range policy, this is disadvantageous to the extent that it may encourage manipulative practices.

PENSION PLANS AS COMPENSATION

The desire to avoid the tax problem has resulted in a widespread adoption of corporate pension plans for executives. Unlike bonuses, corporate contributions to pension funds payable only on the employee's retirement are not taxable to the employee. Consequently, many corporations have established plans that will pay substantial retirement annuities to their executives. For instance, Republic Steel Corporation's plan will pay its president about $50,000 per year upon retirement; and the plan of the Borden Company will pay its present top executive $40,000 per year upon retirement.[12]

Pension plans present their own tax problems. In general, the employer's contribution is not income to the employee if his rights are contingent upon continued service with the company. If his rights are irrevocable and can be taken with him should he leave the company, the payments of the employer are income to the employee in the years they are made.

[12] See proxy statements of respective companies for 1960 and 1961 annual meetings.

The retirement annuity itself is partly taxable and partly exempt, depending on its cost, how paid for, and duration.

From the corporation's point of view, a pension plan presents a problem as to whether or not contributions under the plan constitute a deductible expense. Largely as a result of criticisms of the abuse of pension plans, the Revenue Act of 1942 introduced legal standards for "qualified" pension plans. In general, a qualified plan is one that (1) uses any refund of premiums within the current or following taxable year toward the purchase of the pension annuity; (2) has benefits that do not discriminate in favor of officers, key employees, or employee-shareholders; and (3) provides benefits for 70 per cent or more of the regular employees. The many tax questions which may be involved for both the employer and his employees are highly technical in nature and beyond the province of our discussion here.

"RESTRICTED" STOCK OPTIONS

In an effort to permit a form of executive compensation on an incentive basis, Congress added a new section, 130A, to the Internal Revenue Code in the Revenue Act of 1950. Under this section, stock purchase options which meet certain tests are classed as "restricted" options and do not give rise to taxable income in the year they are received and exercised.[13] The comprehensive Internal Revenue revision of 1954 kept Section 130A as Section 421 and made two important changes. One was a limitation that the option be exercised within 10 years of its granting date. The other change permits the estate or heir of a deceased optionee to exercise the option and sell stock so acquired without observing the two-year limitation.

In order to comply with Section 421, the employee must be an employee of the corporation whose stock he acquires, or an employee of its parent or subsidiary corporation, at the time he exercises his option. Or he must have been an employee within a three-month period before the date he exercises his option. If the option is exercised, the employee must not dispose of his stock within six months from the date of acquisition, or within two years after the option is granted. In other words, stock acquired on May 1, 1956, under an option dated January 2, 1956, could not be sold until January 3, 1958.

The option itself must meet the following tests:

1. The option price for the stock must be *at least* 85 per cent of the fair option price at the time the option is granted.
2. The option must be exercised only by the employee or by his heirs.
3. The option must be exercised within ten years if granted after June, 1954.

[13] Internal Revenue Code, secs. 23 (*p*) (1) *B* and 165 (*a*). These provisions with certain technical amendments were carried over into the 1954 Code, as sec. 404, and secs. 401, and 501 (*a*) respectively.

4. Stock bought under an option must be held for at least six months and cannot be sold for at least two years after the option is granted.
5. The employee must not own more than 10 per cent of the voting stock of the employer, parent, or subsidiary corporation except on a temporary basis under certain restricted conditions, not applicable to the majority of stock options.

Section 421A also includes the so-called "85–95 per cent" rule. If the employee acquires stock under a restricted option and complies with the holding periods, he may still have taxable income at the time he disposes of his stock. If the option price was less than 95 per cent of the fair market value at the time his option was granted, the difference between the option price and the *lesser* of the following items shall be taxable as ordinary income: (1) the fair market value (or selling price) of the stock at the time it is disposed of or (2) the fair market value at the time the option was granted.

If the option price equaled or exceeded 95 per cent of the fair market value at the time the option was granted, the difference between the option price and the selling price (when disposed of by the employee) would be taxable as long-term capital gain.

In spite of these restrictions, the new provisions have been popular with corporations. From the stockholder's viewpoint, the plan has merit in that it gives no wide-open right to milk the corporation. It can be of value to the executive only if the corporation makes progress and is successful. The option can have no value unless the stock develops a market value in excess of the option price. Likewise, the plan encourages the executive to stay with the organization and think in terms of at least moderate-term developments.

Table 45 shows the essential features of several plans adopted under Section 130A (now Section 421), when it first became operative. It is evident that there was no agreement on the features to be used. A wide variation existed as to the amount of stock relative to outstanding stock, maximum to one person, number of persons included, option price, and term.

The 1954 Code added a new provision that makes it less difficult to qualify variable price options. The Code defines a variable price option as an option where value of the stock is the only variable. There is a further proviso that the value of the stock can be taken into account only in a six-month period, including the date the option is exercised.

A variable price option is an option in which the price to be paid by the employee for stock under the option is not determinable at the time the option is granted because it is computed under a formula that is related to the market value of the stock at a date subsequent to the granting of the option. For example, an option is given to X in connection with his employment entitling him to purchase, after the lapse of one year, 100 shares of the stock of A company, his employer, at 85 per cent of market value. The market value of A company stock at the time the option is

granted is $100 per share. One year later the market value of A company stock is $200 and X exercises the option buying 100 shares at $170 per share for a total of $17,000. After holding the stock for 2 years he sells the stock for $250 per share, or $25,000. Since the purchase price of the stock under the option would have been $85 per share had the option been exercised at the date of grant, the option qualifies under clause (ii) of subsection (*d*) (1) (A). His gain under subsection (*b*) shall be the lesser of (1) $250 (market value when sold); or (2) $100 market value at the time the option was granted) minus $85 (the price that would have been paid for the stock had it been exercised at the date the option was

TABLE 45

RESTRICTED STOCK OPTION PLANS*

Company	Common Stock Shares Outstanding	Shares Available under Plan	Maximum Shares to One Person	Minimum Option Price†	Maximum Option Term (Years)
American Safety Razor Corp.	1,413,000	100,000	10,000	100%	10
Bliss & Laughlin, Inc.	525,514	23,000	3,500	100% + $2	5
Bond Stores, Inc.	1,688,383	300,000	15,000	85%	2
Celanese Corp. of America	5,844,954	300,000	45,000	95%	10
Certain-teed Products Corp.	1,623,829	38,400	15,000	95%	5
Chesapeake & Ohio Railway Co.	7,817,099	112,500	20,000	100%	7
Daystrom, Inc.	624,911	62,400	‡	85%	1½
Foster Wheeler Corp.	284,984	15,016	750	95%	7
Interchemical Corp.	661,308	36,750	2,000	100%	5
Loew's, Inc.	5,142,615	250,000	100,000	100%	10
May Department Stores Co.	2,910,466	400,000	20,000	100%	10
Radio Corp. of America	13,881,016	150,000	100,000	100%	5
Sinclair Oil Corporation	12,077,353	598,700	29,935	100%	5
Spiegel, Inc.	1,604,976	100,000	5,000	95%	5
Western Air Lines, Inc.	525,164	35,000	5,250	95%	5
White Motor Co.	690,624	37,500	5,000	100%	5

* *Wall Street Journal*, July 9, 1951, p. 4.
† Expressed as percentage of market price at time option is granted.
‡ Maximum allocation not specified.

granted). Consequently, X upon the sale of his 100 shares of A company stock will be taxable on $15 per share ($1,500) ordinary income and $65 per share ($6,500) capital gain. In determining the capital gain, the amount taxable as ordinary income ($15) is added to the purchase price of the stock ($170).

THE ALCOA OPTION PLAN

The employees' stock option plan of the Aluminum Co. of America is typical of the "restricted" plans created since 1950. It was authorized by the stockholders in April, 1952, for the benefit of those officers and em-

ployees "mainly responsible . . . for the management, growth, and protection . . . of the business . . . [so they will] thereby not only share in the future success of the business but have an increased incentive . . . and a better appreciation of the stockholder's point of view on matters of corporate management." The plan is administered by a three-man committee including the president and at least one director. The committee is authorized to determine which officers and employees should receive options and for how many shares.

No individual may be granted more than 5 per cent of the shares authorized for the plan. The option price may not be less than 95 per cent of market price at time of issuance. It is exercisable by the optionee in whole or in part for a period not to exceed 10 years. If employment is terminated or retirement age is reached, the employee has 3 months to act on his option. In consideration of the option, the employee must remain in the company's employment until age 65. No option is transferable except by last will and testament or the laws of descent and distribution. The effect of any stock-split, stock dividend, etc., is to be reflected in any outstanding options and in the number of shares available for option grants. The company evidently wishes the employees to exercise their options, for on the 6th anniversary of any option 10 per cent of that option or the unexercised part of such option expires and an additional 10 per cent expires on each of the succeeding three anniversaries.

The creation of the plan was accompanied by an authorization of 489,073 shares to be optioned as the committee saw fit. The proceeds from the exercise of the stock were to be used for general corporate purposes.

On May 15, 1952, the committee granted options on 264,400 shares at $70.75 per share. The stock had traded on the New York Stock Exchange that day at 74½–73½ with a close of 74⅜. In April, 1953, the stock was split 2 for 1 and the unissued and outstanding options were adjusted accordingly, i.e., to twice the number of shares at half the price ($35.375/share.) In February, 1954, additional options for 87,350 shares were issued at $58.75. In March, 1955, a 100 per cent stock dividend was declared. This resulted in doubling the shares of option stock and in halving the option prices. The original (1952) options now had a price of $17.6875 per share, and the February, 1954, option price became $29.375 per share.

Aluminum stocks enjoyed a marked advance on the market, so that when the next options were granted on July 1, 1956, the price had to be set at $117.25 on the 198,100 shares optioned. The market was 124–122½ on the option date.

The advance did not prove permanent, and on March 7, 1958, the company canceled the 193,000 shares of options still outstanding from the July, 1956, authorization. It then issued (share for share) 193,000 shares of new options at $68.50 or 95 per cent of average price prevailing on that date. This action came in for considerable criticism on the part of other stockholders, who contended that undue favoritism was being extended

to "insiders." Some "outsiders" contended that the action had cost the company over $9,400,000 without any compensatory benefit. Alcoa was not the only company to cancel and reissue its options at that time. Olin-Mathieson, National Lead, Standard Oil of Indiana, and Pfizer were among others.

Falling stock markets pose difficult problems to the managers of option plans. The options are granted for at least two reasons. One is to furnish a means of eventually providing greater income to the management via the capital gains route. The other is to create some ownership incentive for what is becoming a professional management class. The first objective cannot be attained if the stock is selling below option price. Prices in the stock market are determined by many factors only one of which is company prospects. Consequently, reissuance appears logical in periods of declining stock prices in order to regain the twin objectives of reward and incentive.

TABLE 46

THE ALUMINUM COMPANY OF AMERICA
RESTRICTED STOCK OPTION PLAN, 1952–60

Year	Options Exercised (Shares)	Company Proceeds from Sales to Optionees	Fair Market Value on Dates Exercised*
1952	26,236	$ 464,049	$ 557,000
1953	95,310	1,685,795	2,475,000
1954	425,576	7,627,000	15,909,000
1955	272,141	5,122,360	16,622,000
1956	171,411	3,434,164	17,903,000
1957	54,222	1,094,546	4,795,000
1958	37,538	966,477	2,787,000
1959	38,101	1,999,574	3,487,000
1960	30,875	954,673	2,745,000
Total	1,151,410	$23,348,638	$67,280,000

* Based on mean value for each month in which options were exercised.

By 1959, at least some incentive had been restored for option holders. With the stock selling at about $100 per share, new options were granted for 218,325 shares at $99.875. In this case, the options were granted at 100 per cent of the average of the high and low prices on November 27. As this is written (June, 1961) this group of options had been reduced to potential value only, because of a current market price of 75.

The effectiveness of restricted options in providing both possible owner participation and reward for the participants cannot be judged by one case or by a single ten-year period, especially when the period is noted for broad based economic expansion. However, Table 46 shows what it has done in the case of a large aluminum company.

DEFERRED COMPENSATION AND OTHER PLANS

Upper-income executives are not interested in current salary increases because high tax rates will absorb most of it. As an outstanding instance of what taxes do to gross income, General Motors Corporation estimated that its then president, Harlow H. Curtice, received a total of $776,400 in 1955 and was able to keep only $121,328 after taxes. To offset such conditions as these, a growing number of companies give their key executives conditional employment contracts. Under these contracts the company agrees to pay an executive full or partial salaries after he retires if he meets certain conditions, such as being with the company a certain number of years, acting as a consultant to the company, or not taking a position with a competitor after he retires. This type of retirement salary can run indefinitely or for a fixed time under the conditions which would be agreed upon both by the employer or employee. However, in order to get tax benefits, it is essential that conditions must be included in the employment contracts.

PHANTOM STOCK PLANS

The phantom stock plan is a fairly recent development aiming at providing management incentive and in some cases a form of deferred compensation. In phantom stock plans, the participants are assigned stock "units" and then enjoy the benefits of stock ownership without owning the stock (which, in fact, may not exist). In one of the earliest plans, the participants were assigned units equivalent to shares. Dividends were paid on the units equal to the dividends declared and paid on outstanding shares. Any stock splits or stock dividends were accompanied by appropriate adjustments in the "units." Upon retirement, the executive could select any date in the two following years to "sell" his units and receive from the company the amount of appreciation from the date the units were granted to the date of "sale."[14] This plan was contested by a stockholder's suit. The court approved the plan insofar as dividend payments were concerned but set aside the post-retirement "capital-gain" provision. The court reasoned that the dividends were compensation properly related to value of services rendered but that increases in market value were the result of many forces other than earnings of the corporation.[15]

The "Deferred Compensation Unit Plan" of the Koppers Company has enjoyed greater success in the courts because of a closer tie-in with the value received by the company. Under the Koppers plan a committee of directors, who are ineligible for the benefits of the plan, award units to

---

[14] *The Management Record*, April, 1960, p. 2.

[15] *Berkwitz* v. *Humphrey*, 163 Fed. Suppl. 78.

the eligible employees. Each unit is equivalent to a share of stock in the company although no stock is issued. The units in each employee's account are credited with dividends paid or stock splits. When the employee retires, he receives the current value of his unit account spread over a ten-year period. He has the option of deferring any receipts for three years and taking a lump sum payment equal to the then current value. The lump sum settlement is subject to the limitation that it cannot exceed the highest value between the assignment of the units and date of retirement. The conditions are typical of deferred compensation plans: the employee must have been employed at least five years; must agree to serve as a consultant for ten years; and cannot engage in any competitive activity with Koppers.

The Delaware Supreme Court upheld the plan in a decision rendered in October, 1959.[16] A stockholder had attacked the post-retirement gain provisions on the ground that there was no reasonable relationship between the amounts that the company might have to pay and the employees' services. Unlike an ordinary option plan, the liabilities of the company were unknown, and the employee ventured no capital in enjoying the benefits of the unit plan. In its defense, the company contended that the plan was designed primarily to retain the services of valued employees and was admirably designed for this purpose. In upholding the plan, the court held that adequate consideration had passed from the employees to the company and that the plan was no more vulnerable to attack than ordinary option plans which had received wide approval.

ECONOMIC BASIS OF BONUS PAYMENTS

An economic appraisal of the bonus principle is more difficult to establish with any degree of finality. The problem contains both an internal and an external setting. Reference has been made to the former, and the difficulties of trying to allocate the various interests of a going concern their respective and just shares of the total output have been suggested. The external aspects are even more confusing and evasive. The essence of the matter may be put in the form of a question: What effect does the distribution of income or wealth have upon the prosperity of a nation? It is not within the confines of this study to answer this question, but its pertinency arises more especially through its relationship to corporate policy. Until the past few years, there would be little likelihood that such a matter would be found on the agenda for a directors' meeting; today, there is little escape from this issue. The Securities and Exchange Commission is publishing salaries and security holdings of prominent corporate officials, and these matters are being scrutinized by the public at large. In times of universal prosperity, they would likely attract little at-

[16] *Lieberman* v. *Becker*, 155 A. 2nd. 596.

tention; but in periods of depression, they are regarded with much suspicion. Does not the receipt of large returns by certain favored individuals automatically mean less available for the masses? By and large, the question is so easily answered in the affirmative that sentiment spreads rapidly against those companies engaged in the practice of favoring their executives with excessive returns.

The day is probably past when business enterprise can confine its attention to matters of its own household. More than ever, the affairs of the nation will necessitate action on the part of corporate directors. In the past, business has tended to look in the direction of government for various favors and privileges; but if the tendencies of recent years continue, it is likely that the direction of the line will be reversed. Government will expect more of business, both in the way of taxes and in the way of responsibility.

Is the president of a large life insurance company worth $250,000 per year? Is the president of a large auto corporation worth nearly $500,000 per year? Who shall be the judge of such questions? Formerly, these were matters of great privacy and were settled in hushed tones around the directors' table. Today, they are viewed as items of public policy; and it behooves the directors to give proper consideration to public reaction.

EXECUTIVE COMPENSATION IN SMALLER CORPORATIONS

Most of our discussion of executive compensation has implied a relatively large corporation, one in which the executives are employees rather than owners. The situation is quite different in the smaller corporations. Fully half the corporations have three or less stockholders. Usually, the principal stockholders is also the chief operating executive; and frequently, all the stockholders are on the payroll in one capacity or another. In such cases, there is no real distinction between employer and employee; and, from the corporation's viewpoint, it is not too important whether the earnings are drawn off as salaries or as dividends. However, from the owner-manager's viewpoint there may be substantially different tax results. As was shown earlier, executive salaries are far more important in small than large corporations.

As we move up the corporate size-scale, we find that stockholder lists become longer and the interests more diversified. The principal executive may still be the largest stockholder, but the bulk of the minority stockholders will no longer have any employee interest. It is in such cases that executive salaries may be subject to greatest abuse. Not only may the salary sometimes be set above a reasonable figure, but various forms of nonmonetary compensation may also become important. While this may be generally true of larger corporations, it is also true that large volumes of business can support large amounts of executive compensation. Barring cases of outright fraud, there is no satisfactory protection against abuse

other than stockholder pressure in corporations of any size. In fact, it may be said that most cases of abuse of privileges within corporations arise from lack of stockholder interest in corporate affairs.

QUESTIONS AND PROBLEMS

1. Do you believe it is possible to provide adequate or effective incentives for management by other than monetary means? Explain.
2. "Pensions are simply frozen wages and this converts them from a direct expense, subject to control, to fixed overhead without control." Discuss, and consider the effects on the financial position of the corporation.
3. Do you think that executive salaries should bear some relationship to the dividends paid to the stockholders?
4. "The payment of a large percentage of net income as salaries to officers is to be expected in the case of small companies because here the executives are likely to own a large amount of stock and the salaries may be offset by the curtailment of dividends." Do you think that this constitutes justification for the difference in the relationship between salaries and net income as between large and small companies?
5. "A bonus system offers more incentive to young executives seeking to advance than to those who are already at the top." Discuss.
6. Discuss the relative advantages of cash and stock bonuses. Do you think that any form of bonus is essential if the salary return is sufficiently high?
7. What are the dangers of selling stock to officers at a price below the market?
8. What is your opinion of the bonus plan of the American Tobacco Company, particularly as to the original use of 1912 as a base year?
9. "The type of loyalty engendered by the bonus system will fail when some other company makes a better offer." Discuss.
10. Indicate the difficulties of stockholders bringing suit asking for a proper accounting for their funds.
11. Discuss the influence of the federal income tax on salaries, bonuses, and pension policies.
12. How high can income tax rates go before they destroy incentive and thus reduce productivity?
13. Compare the bonuses available to executives of American Tobacco Co. since 1935 with earnings results of that company *vs.* other tobacco companies.
14. Evaluate phantom stock plans in comparison with restricted stock options as to the ability of each type of plan to achieve the goals of proper incentive and ownership.

REFERENCES

Baker, J. C. *Executive Salaries and Bonus Plans.* New York: McGraw-Hill Book Co., Inc., 1938.

———. "Limiting Executive Salaries in Wartime," *Harvard Business Review,* Autumn, 1942, pp. 50 ff.

Davidson, Clinton. "Incentives for Executives—How to Make Management Worthwhile," *Credit and Financial Management,* August, 1946, pp. 16 ff.

LASSER, J. K., and GOLDSTEIN, MEYER M. "Meeting the Six Goals of Executive Compensation," *Dun's Review,* June, 1953, p. 25.

PATTON, ARCH. "Executive Compensation in 1960," *Harvard Business Review,* Vol. XXXIX, No. 5 (September–October, 1961), pp. 152–57.

———. *Men, Money, and Motivation,* New York: McGraw-Hill Book Co., 1961.

———. "Phantom Stock Plans," *The Management Record,* Vol. XXII, No. 4 (April, 1960), pp. 2–5.

———. "Trends in Executive Compensation," *Harvard Business Review,* Vol. XXXVIII, No. 5 (September–October, 1960), pp. 144–54.

———. "What Is an Executive Worth?" *Harvard Business Review,* Vol. XXXIX, No. 2 (March–April, 1961), pp. 65–73.

ROBERTS, DAVID R. *Executive Compensation.* Glencoe, Ill.: The Free Press, 1959.

SANDERS, T. H. *Effects of Taxation on Executives.* Boston: Harvard University, 1951.

TEMPORARY NATIONAL ECONOMIC COMMITTEE. Monograph No. 11. *Bureaucracy and Trusteeship in Large Corporations.* Washington, D.C.: U.S. Government Printing Office, 1940.

WASHINGTON, GEORGE T. "The Corporation Executive's Living Wage," *Harvard Law Review,* Vol. LIV, No. 5 (March, 1941), pp. 733 ff.

Chapter 24 ►

DIVIDENDS AND DIVIDEND POLICIES

INCOME REMAINING after recognizing all costs of operations, including fixed charges and income taxes, is available for paying dividends; or it may be retained in the business, where it represents additional capital. How much income is paid out and how much is retained is a matter of judgment for the directors. What a given company will do is a product of many factors, including the amount of net income, its stability, the need for additional capital in the business, and the past dividend practices of the particular corporation. The policy followed by an individual corporation is important to its financial prospects and to its stockholders; the policy followed by corporations generally is of considerable importance to the economy because of the substantial sums involved.

AMOUNT OF CORPORATE EARNINGS

Corporate net earnings make up a much smaller and more fluctuating proportion of national income than is popularly supposed. Corporate earnings after taxes amounted to $8,300 million in 1929. This was equal to 9.4 per cent of the total national income for that year. In the following year, 1930, profits fell to $2,500 million, or 3.3 per cent of the national income. In each of the years 1931, 1932, and 1933, corporations in the aggregate reported a deficit. Not until 1936 did corporate profits after taxes reach as much as 6 per cent of national income, and in no year through 1960 did the figure reach the relative importance it held in 1929. (See Table 47 for intervening data.) To be sure, in 1959, corporate profits—dollar-wise—did reach a record high level, amounting to $23.8 billion; but as a percentage of national income, they did not even approach the 1929 peak except in 1947, 1948, and 1950. In the years since 1955, there has been evidence of a downward trend in the percentage. Clearly, corporate profits in the aggregate have not kept pace with the growth in the economy.

TABLE 47

NATIONAL INCOME DATA, 1929–60*
(000,000,000 Omitted)

Year	Corporate Profits after Taxes	Dividends	National Income	Corporate Profits as Percentage of National Income†	Dividends as Percentage of National Income†	Dividends as Percentage of Corporate Profits†
1929	$ 8.3	$ 5.8	$ 87.8	9.5	6.6	69.9
1930	2.5	5.5	75.5	3.3	7.3	22.0
1931	−1.3	4.1	59.7	Deficit	6.9	Deficit
1932	−3.4	2.6	42.5	Deficit	6.1	Deficit
1933	− .4	2.1	40.2	Deficit	5.2	Deficit
1934	1.0	2.6	49.0	2.0	5.3	26.0
1935	2.2	2.9	57.1	3.8	5.1	131.8
1936	4.3	4.5	64.9	6.6	6.9	104.6
1937	4.7	4.7	73.6	6.4	6.4	100.0
1938	2.3	3.2	67.6	3.4	4.7	139.1
1939	5.0	3.8	72.8	6.9	5.2	76.0
1940	6.5	4.0	81.6	8.0	4.9	61.5
1941	9.4	4.5	104.7	9.0	4.3	47.9
1942	9.5	4.3	137.7	6.9	3.1	45.3
1943	10.5	4.5	170.3	6.2	2.6	42.8
1944	10.4	4.7	182.6	5.7	2.6	45.2
1945	8.3	4.7	181.2	4.6	2.6	56.7
1946	13.4	5.8	179.6	7.5	3.2	43.3
1947	18.2	6.5	197.2	9.2	3.3	35.7
1948	20.3	7.2	221.6	9.2	3.2	35.5
1949	15.8	7.5	216.2	7.3	3.5	47.5
1950	22.1	9.2	240.0	9.2	3.8	41.6
1951	18.7	9.1	277.0	6.8	3.3	48.7
1952	16.1	9.0	289.5	5.6	3.1	55.9
1953	17.0	9.3	303.6	5.6	3.1	54.7
1954	17.0	10.0	299.7	5.7	3.3	58.8
1955	23.0	11.2	330.2	6.9	3.4	48.7
1956	23.5	12.1	350.8	6.7	3.4	51.5
1957	22.3	12.6	366.9	6.1	3.4	56.5
1958	19.1	12.4	367.7	5.2	3.4	65.3
1959	23.8	13.4	390.6	6.1	3.4	56.2
1960‡	23.0	14.0	418.4	5.5	3.3	60.9

* Source: *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, January 24, 1956), pp. 173, 223. *Ibid.*, 1961, pp. 138, 192.
† Percentages computed by authors.
‡ Preliminary; fourth quarter estimated, Council of Economic Advisors.

AMOUNT OF DIVIDENDS

Dividends constitute a more stable portion of national income than is true of profits. This is because corporations usually distribute less than they earn in good years, thus providing a measure of savings for future dividends and reinvestment. Table 47 shows the data on dividends and

profits from 1929 to an estimate for 1960. The dollar amount of dividends shrank nearly 65 per cent from 1929 to 1933 and was not fully recovered until 1946. Moreover, in eight of the thirty-two years shown, dividends exceeded profits after taxes. Some of the reasons for this situation are worthy of examination.

ECONOMIC BASIS OF DIVIDENDS

In the system sense, corporate earnings are the reward that accrues to stockholders for the provision of venture capital. In terms of economic principle, this reward should be sufficient to pay the stockholders a normal interest rate plus a reward for the risks assumed. Dividends are the medium through which this is accomplished, but dividends are an expression of corporation policy as well as economic action.

Dividends may be paid when not covered by current earnings if the cash position is sound and if sufficient surplus has been accumulated. It is not at all uncommon for well-intrenched companies to pursue this practice in depression years as a means of maintaining investor following and support. However, in the long run, dividends are dependent upon net profits, although the actual amounts paid will obviously be affected by corporate policy with respect to the retention of earnings in the business. The allocation of net profits to dividends and surplus will naturally vary from year to year as well as be influenced by the nature of the business.

In the years 1931–33, when corporations in the aggregate had a deficit, stockholders received their return in substantial measure, in part because some companies had earnings even in those years and in part because some of the earnings of prior years had not been paid out and were available for dividend purposes. Dividends can be *declared* out of prior years' earnings, but they must be *paid* out of cash. Hence, the cash or liquid assets position of a corporation affects materially its ability to pay cash dividends, whether earned or not.

Dividend policy in the deficit years 1931–33, and more particularly in the early New Deal years 1934–39, was definitely colored by current economic and political thinking. Some economists had always questioned the advisability of excessive holdings of cash by corporations. It was contended that corporate withholdings helped to destroy the balance between production and consumption unless retained earnings were immediately and fully invested in productive uses. During the thirties, this view became widely accepted and was more fully formulated as the "oversavings–under-consumption" explanation of the business cycle. The widespread acceptance of this viewpoint was undoubtedly an important factor in influencing corporations as a whole to pay dividends in excess of earnings.

In addition, political policy favored dividend disbursements and found its expression in a special tax levied on undistributed profits in 1936 and

1937. This undoubtedly increased the dividend disbursements of the profitable concerns in those years. A further factor of some importance was the rather widespread acceptance of the idea that a lack of opportunity for the use of investment funds had developed. While subsequent events did prove this view to be wrong, New Deal policies were accepted as antagonistic and dangerous by many investors and corporate directors.

In the years since 1939, dividends have not been very large in relation to corporate earnings. Two reasons are apparent. One is that while dividend disbursements in terms of dollars have been maintained at a high and rising level, they have not increased as much as corporate income. As a result, dividend payments have been relatively small *in relation to* income. The other is the remarkably large volume of business activity which had to be financed during, and since, the war years. The increased physical volume was accompanied by rising costs, so that all concerns were under pressure to increase their working capital; consequently, it was necessary to restrict dividend disbursements as one means of providing additional funds. In the postwar years the seemingly never ending cycle of expansion required an increasing amount of cash. Many companies were unwilling to go into debt, and financed a large part of their expansion out of retained earnings and depreciation accruals. Even companies which as a matter of tax policy financed part of their expansion by debt required further large sums for capital expenditures and additional working capital.

This brief review of the total situation of corporate dividends in the economy, together with some of the reasons for their fluctuation, enables us to turn now to the variations in the policy of individual corporations and to develop some of the factors that should be considered in shaping dividend policy.

INDIVIDUAL MANAGEMENT AND DIVIDENDS

In noting the relationship between individual management and dividend policy, attention may be directed to the two possible extremes: those organizations which are niggardly in dividend payments and those which are more liberal. Typical of the former type are the Aluminum Company of America and the Radio Corporation of America. The present Aluminum Company, organized in 1925, did not pay a single cash dividend during the first fourteen years of its existence, although it had enjoyed earnings in all but four of those years. In 1928, the company did pay one share of Aluminum, Limited, stock for each three shares of Aluminum Company stock. It has paid dividends since 1939. In recent years dividends have been at a more generous rate. In 1952 for instance the company paid $3.00 a share. In 1953, after a 100-per-cent stock dividend the stock was placed on a $1.20 basis. Total cash dividends in this year equaled $3.15 a share, on the old basis. In 1954, dividends were increased

to $1.60 a share. In 1955 another 100-per-cent stock dividend was declared. Since 1956, the stock has been on an annual basis of $1.20 a share. This rate equals $4.80 per share on shares outstanding in 1952, before the two 100-per-cent stock dividends, and so contrasts with the $3.00 actually paid per share in that year.

The Radio Corporation of America was organized in 1919 and through the year 1936 paid no cash dividends. Prior to 1929, when its stock was split 5 to 1, record earnings had been $15.98 per share. Earnings from 1929 through 1946 were quite modest. In 1937–38, the company paid a cash dividend of $0.20 a share, which rate was also paid 1940–47; increased to $0.30 in 1948; $0.50 in 1949. Since 1949 dividends have fluctuated somewhat more in line with earnings. They still have not been overly generous, not rising to 50 per cent of earnings until the 1956–59 period when dividends ranged between 55 and 75 per cent of earnings. In 1950, a cash dividend of $1.50 per share was paid; $1.00 during 1951–53; $1.20 in 1954; and $1.35 in 1955. From 1956–59, the rate was $1.50 plus a 2 per cent stock dividend in 1959. In 1960, $1.00 plus 2 per cent in stock was paid.

The only reasonable explanation for the type of policy that existed in the earlier years is that the management believed it wise to conserve cash and to make it available for expansion. On the other hand, management may be lacking in its failure to observe a sense of proper responsibility to the stockholders who invest for the purpose of realizing a return. Especially would this be true if investors were invited to participate without information to the effect that dividends would not be paid for an extended period of time. The declaration of such policy would at least have the merit of due notice, but failure to do so is a use of other people's money on the basis of quiet concealment. In the case of the 1960 dividend reduction, the company explained that the action was taken to conserve cash in order to finance growth, particularly in the electronic data-processing division.

At the other extreme, there are a number of corporations that are generous in dividend disbursements, without, of course, jeopardizing the financial soundness of the company. This policy is best illustrated in the record of the American Telephone and Telegraph Company. From 1922–58, the telephone company maintained a dividend rate of $9.00 per share on common stock, in spite of the fact that earnings failed to cover dividends in many of the years following 1932. Recognizing a sense of obligation to its many stockholders, the management believed that the stockholders were entitled to the established dividend rate as long as the financial condition reasonably permitted the fulfillment of this objective. It was maintained that the stockholders advanced capital to the corporation during more prosperous times in the form of both new commitments and earnings in excess of dividend payments which were retained in the business. Capital was not being utilized at the previous rate for

purposes of broad expansion, and the strong cash position made possible the payment of the dividends. The existence of these more technical factors, however, should not cause one to overlook the more fundamental philosophy of a deep sense of responsibility the management has toward the stockholders. This was especially evidenced in the years 1942–46, when the company continued its dividend at the $9.00 rate although it failed to earn its dividend in three of those years. In 1959, the stock was split 3 for 1 and put on a $3.30 annual rate. This rate was increased to $3.60 beginning with the July, 1961, quarterly payment.

Within these extremes, there are many variations of individual policy. In fact, standardization would be almost too much to expect in a diverse business with wide ranges as to size of companies and as to amount of risk experienced. Broadly speaking, there is a marked variation in dividend policy on the basis of the size of company. The smaller corporations are more closely held. More than half of them have three or less stockholders. Frequently, the officers are the sole stockholders and may, therefore, be expected to pay dividends to suit their personal convenience. Indeed, earnings may be drawn off in substantial measure through the payment of salaries. Under these circumstances, such distributions of dividends as are made may be the result of tax policy. Large corporations with scattered small stockholdings must necessarily recognize a sense of public responsibility which is not equally incumbent on smaller organizations, where the relations are more personal and common understanding is more readily facilitated.

In large corporations, the elimination of personal bias is particularly desirable. Valuable as personal opinion based upon wide experience may be, it still needs the support of factual analysis to meet the requirements of public trusteeship. Even here, marked variations will continue as a characteristic of dividend policy among the various individual companies and fields of enterprise.

There are a number of considerations that determine whether a corporation follows the policy of distributing dividends on a limited or an irregular basis or adopts the policy of liberal and regular payments. These may now be examined to indicate their varying importance in determining dividend policy of individual concerns.

NEED FOR EXPANSION

Many corporations limit dividends and retain earnings in the business in order to finance planned expansions. Large corporations with a national following of investors ordinarily have access to other sources of funds, but they find retained earnings a particularly advantageous source. For one thing, there is no pressure to pay interest or dividends on surplus. On the contrary, if the expansion is successful, the return on the retained earnings will accrue to the benefit of the stockholders.

Small corporations often have no alternative other than to finance a large part of their growth through the retention of earnings. Small companies find themselves excluded from the organized capital market by the factor of their size. The security markets are not geared to the flotation of small issues at reasonable expense. The other alternative is the commercial banking system; but here, limitations on the term of loan and the presence of legal lending limits are handicaps. The best, and often the only, solution is to grow from within by restricting dividend payments. Further analysis of this policy will be presented in the next chapter.

DESIRE FOR FINANCIAL SOLVENCY

While some corporations may have an opportunity for expansion, all corporations have the desire for financial stability. The swings of the business cycle affect all businesses to a greater or lesser degree. Profitable years are followed by less profitable or deficit years. The deficit years are easier to weather, and financial solvency can be maintained more successfully, if the assets have been built up through retention of earnings. However, the mere fact of retention does not in itself create financial solvency. Solvency depends on financial management and the form in which the earnings are invested. If the added investment is in cash and other current assets, the company will have greater resistance to poor business conditions. On the other hand, if the retained earnings are all invested in fixed assets without proper attention to current assets, little will be gained in terms of financial strength.

A complete application of this policy would result in no dividend payments. It should be pointed out that the policy of retention strengthens financial stability but gives no real assurance of continuous dividend payments. In practice, most corporations follow a policy of compromise and pay out varying proportions of earnings.

TAX CONSIDERATIONS

Corporate income is subject to a substantial measure of double taxation. It is taxed once under the federal (and frequently state) corporate income tax and again under the personal income tax when it is paid as dividends to the stockholders. As a result, the directors of closely held corporations must consider the effect of dividends upon the total tax position of the principal stockholders. Frequently, the tax position of the stockholders will be such as to provide little desire to receive additional income in the form of dividends—taxes would take too large a slice of the addition. When the stock is widely held, this will not be an important factor. However, if the stockholders' individual tax situations are such as to encourage retaining earnings, the directors must face the problems in-

cident to what was formerly Section 102 of the Internal Revenue Code. Substantially all of the language of this section, as well as certain new provisions are now contained in Sections 531, 532, 533, 534, 535, 536, and 537 of the 1954 Code.

The essential features of this aspect of the code levies a surtax upon improperly retained earnings. Broadly speaking, earnings are improperly retained when the purpose of the retention is to avoid personal income taxes on the stockholders or when the corporation cannot show a business necessity for the added funds. A business necessity exists when the retained earnings are needed to expand plant facilities, to finance added inventories, or to meet some unusual business contingency. While the surtax is actually levied rather infrequently, it constitutes a definite factor in the dividend calculations of management, especially the management of small corporations. It is not a simple problem when the dividend policy must be fixed by management in the current year based on foresight, whereas the review will be made by the tax examiner one to three years later with the benefit of hindsight.

However the task of management was made easier by new provisions in the 1954 Code. Thus, Section 534 generally places the burden of proof that improper accumulations have been made on the Internal Revenue Service, instead of on the company as was formerly the situation.

TYPE OF INDUSTRY AND STABILITY OF INCOME

Another conditioning influence on dividend policy is the type of industry. Obviously, industries that are characterized by stability of income may formulate a more consistent policy as to dividends than those having an uneven flow of earnings. For example, public utilities are in a much better position to establish a relatively fixed dividend rate than various industrial groups. Mining companies may go through a long period of development before paying any return at all on the equity investment and then blossom forth with exceptional payments. Likewise, other new industrial developments which are promoted independently will experience both deferred and fluctuating earning power so as to prohibit the formulation of a clear-cut dividend program. In such instances, the chief item which is subject to policy formation is the extent to which earnings will be retained for plant improvement and expansion.

In the last analysis, the amount and regularity of income are probably the most important bases of determining dividend declarations. Thus, until recent years, many railroads were forced to forego the payment of dividends; whereas established industrial companies were able to return to a dividend schedule following the curtailment of the early thirties. During the same period, the public utilities have had a fairly consistent record.

EMPHASIS UPON REGULARITY

By far the most important single factor in determining dividend policy is the emphasis placed upon regularity of payment. American corporation law has always permitted the use of prior years' earnings for the payment of the current year's dividends.[1] As a result, one of the early criteria of corporate success became the regularity of dividend payments and the number of years dividends were paid without a break. Not all companies could adhere to this standard, nor did all choose to do so. Some apparently preferred to determine their policies on a year-to-year basis. Needless to say, there are arguments in favor of both methods. In favor of basing dividends on current earnings only are the following arguments:

1. Current returns are said to provide the best index of a company's ability to pay dividends.
2. An accumulated deficit arising out of previous years is frequently eliminated by the process of recapitalization. In effect, this may be the cause of paying dividends before restoration of the original investment.
3. Dividends based upon current earnings cause greater irregularity of payments and force the stockholders to pay more attention to corporate affairs.

Arguments in favor of basing dividends on current earnings and accumulated surplus are as follows:

1. Greater regularity of dividends is permitted.
2. Regularity cultivates an investment rather than a speculative attitude toward stocks.
3. The payment of smaller dividends in prosperous years permits the accumulation of surplus which may prove to be a differential of safety in periods of ensuing depression.

Some corporations have been able to establish dividend records of remarkable consistency (a few of these are shown in Table 48); but, in order to maintain their records, they have found it necessary at times to delve into the surplus account. This was particularly in evidence in 1921 and again in the years from 1932 to 1938. Frequently, earnings conditions necessitated more drastic measures than mere invasion of surplus; and many concerns were compelled to omit dividends entirely. In a few cases, long-established records were interrupted. Outstanding among such companies may be mentioned Swift and Company, Western Union Telegraph Company, Illinois Central Railroad, and New York Central Railroad. The chief danger inherent in the preservation of a dividend record is the possibility of sacrificing the ultimate financial standing of a corporation purely for the sake of pride or reputation.

---

[1] English practice, on the other hand, favors limiting dividends to income of the current year. Surplus retained from prior years' earnings is not used for dividends; and, as a result, dividends must be suspended in years of deficit.

As a means of reviewing a dividend program over a long period of time, a brief summary may be made of the record of the United States Steel Corporation. Although the steel combination has never failed to pay on its preferred stock, it was forced in the period from 1933 to 1935 to reduce the regular $7.00 dividend to $2.00.[2] There have been many years in which the company has failed to pay on its common stock. The most noticeable feature of the common stock dividend record or policy is the absence of extremes either of the short or long type. For example, anything beyond what is considered the regular dividend is termed an "extra dividend." From 1910 to 1914, the stock was on a 5 per cent basis, although only 4¼ per cent was paid in 1914 and nothing in 1915. Commencing with June, 1916, the stock was once more placed on a 5 per cent basis and continued so until March, 1926. During this same interval, extras

TABLE 48

CONSECUTIVE YEARS OF DIVIDEND PAYMENTS BY SELECTED COMPANIES, THROUGH 1960

Class of Corporation	*Number of Years*
Industrials:	
Diamond National Corp.	78
General Electric Co.	62
National Biscuit Co.	62
Procter & Gamble Co.	70
Pullman, Inc.	94
United Fruit Co.	62
Westinghouse Air Brake Co.	86
Public Utilities:	
American Telephone and Telegraph Co.	99
Consolidated Edison Co. of New York	67
United Gas Improvement Co.	75
Railroad:	
Pennsylvania Railroad Co.	113

were also very numerous, for the last two years of the period being ½ per cent quarterly. This meant that the stock was actually on a 7 per cent basis. At other times, quarterly extras were as high as 3 cent; but this was due to war rather than to normal business conditions. The maximum the corporation has ever paid in cash dividends to common stock in a single year is 16¾ per cent in the year 1917. From 1926 to 1940, the maximum annual dividend was $8.00; and during the years 1933–40, dividends were omitted with the exception of $1.00 paid in 1937. From 1941 to 1946, an annual rate of $4.00 was maintained. In 1947, $5.25 was paid; in 1948, a $1.00 extra dividend was paid in addition to the $5.00 regular. In 1949, the stock was split 3 for 1; and $2.15 was paid on each new share. In 1950, $3.55 was paid on these new shares. From 1951 through 1953, the rate was $3.00 per share; in 1954, it went to $3.25 per share. In 1955, the stock was

[2] All the arrearages on preferred dividends were paid off in 1936 and 1937, and the stock returned to its full rate in 1938.

again split, this time on a 2 for 1 basis. The new stock was placed on a quarterly basis of $0.65 a share in the latter part of 1955, which rate was continued in effect during the first half of 1956. It has been on a $0.75 quarterly basis since January, 1957.

There are many outstanding points in the dividend policy of the United States Steel Corporation. Among other features, the following are significant:

1. Dividends were paid but were not placed on a specified basis until the corporation was well established.

2. Care has been taken to distinguish between normal and extra dividends. The latter are changed into regular dividends only upon assurance that their payments are likely to be continued.

3. In spite of the occasions when dividends were not paid, dividend payments have been more regular than sporadic.

Such policies are primarily for the welfare of stockholders and not for the professional speculators who are favored by unusual and unexpected news and are dulled by the monotony of regular dividend declarations. The need for a stable dividend policy has been made all the more necessary today because of the extensive public ownership of corporations. The small and casual stockholder is likely to have a greater need for a regular dividend; and, more important to the corporation, the small stockholders may not appreciate fully the reasons underlying the abrupt cessation of dividend payments.

In contrast to the dividend record of the United States Steel Corporation and the other consistent dividend payers noted above, the records of the following companies may be noted for the sake of example:

United States Rubber Company. From 1895 to 1960, dividends have been passed as follows: 1896, 1898, 1901–11, 1915–19, 1921–40, and 1942.

Bethlehem Steel Corporation. Although the company was organized in 1904, the initial dividend on common stock, amounting to 30 per cent, was paid in 1916. Dividends continued until 1924 and were dropped until 1929, from which date they were paid until 1932. Dividends were paid again in 1936 and 1937, omitted in 1938, and paid in 1939–60.

Goodyear Tire & Rubber Company. Dividends were paid on the common stock from 1899 to 1903 at a rate of 6 per cent and again from 1909 to 1914. From 1915 to the middle of 1920, 12 per cent was paid annually, followed by a 2½ per cent quarterly dividend in September, 1920. None was paid from that date to August, 1929, when the stock was placed on a $5.00 basis. In 1931, the rate declined to $3.50, and to $0.25 in 1932. From 1933 to 1936, the company paid no dividends; but $2.50 was paid in 1937, $0.25 in 1938, $1.00 in 1939, and $1.25 in 1940. In 1941, $1.37½ was paid; 1942, $1.25; 1943–45, $2.00; 1946–49, $4.00; 1950, $5.00. In 1951 the stock was split 2 to 1; altogether $6.00 was paid in 1951. In 1952–53, $3.00 was paid in cash, plus 5 per cent in stock in 1952, and 3 per cent in stock in 1953. In 1954, the stock was again split 2 to 1, and a total of $3.25 paid during the year. In 1955, $2.00 per share was paid. It was on a $2.40 basis during 1956–58 with 2 per cent stock dividends in each year. The stock was split 3 for 1 in 1959 and placed on a $0.90 plus 2 per cent stock annual basis.

These irregular dividend payments are not necessarily open to condemnation because, in many instances, the irregularity was the result of unsuccessful operations as much as policy. In general, stable dividends are most frequently maintained by (1) corporations of long standing, i.e., those that have been seasoned by time and experience; and (2) corporations producing goods and services of the necessity type and therefore likely to have stable incomes.

LEGAL BASIS OF DIVIDENDS

The foregoing aspects of dividend policy have dealt with questions relating mainly to individual management; but, in addition, there are certain basic principles which tend to be more static and are largely external in character. These are the legal and economic phases. In the eyes of the law, the corporation is created principally for the benefit of the stockholders.[3] In recent years, there has been a tendency to give a broader social implication to corporate matters; but, by and large, the criterion of legal action is still presumed to be rooted in the rights of the specific parties affected. Hence, the legal basis for the treatment of disputes concerning dividends is found almost entirely in an examination of the respective rights of the stockholders and of the directors.

In considering the rights of stockholders, it must be remembered that they, in turn, delegate to a board of directors the power to determine when dividends shall be paid. Not even a majority vote of the stockholders can interfere with the authority of the board in the conduct of the ordinary business of the corporation.[4] Only under extreme circumstances or upon evidence of bad faith is the court likely to reverse the decision of the board of directors. The courts generally believe that their arbitrary ruling should not be substituted for the discretion of the directors. Even where a large surplus exists, stockholders would have little prospect of securing a court order to compel the payment of dividends.[5] "The ultimate test is the good faith of the board and the reasonableness of its policy in retaining the surplus profits in the business."[6]

One of the few cases where the court compelled the payment of additional dividends is that of *Dodge* v. *Ford Motor Company*.[7] The company had capital stock of $2,000,000, and accumulated surplus of $112,000,000, and cash amounting to $52,000,000. Declaring that a business cor-

---

[3] See E. M. Dodd, "For Whom Are Corporate Managers Trustees?" *Harvard Law Review*, Vol. XLV, pp. 1145 and 1146, for the statement that "the directors and other agents are fiduciaries carrying on the business in the sole interest of the stockholders."

[4] *Stevens on Corporations* (St. Paul: West Publishing Co., 1936), chap. xvi, sec. 138.

[5] *Trimble* v. *American Sugar Refining Co.*, 61 N.J. Eq. 340, 48 A. 912.

[6] *Stevens on Corporations*, chap. xii, sec. 99.

[7] 204 Mich. 459.

poration was operated primarily for the profit of the shareholders, the court ordered the declaration of a dividend equal to one half the "cash surplus." Clearly, however, the element of reasonableness played an important part in this instance; and it is apparent that the surplus was abnormally large in comparison with the capital stock.[8] Except under extreme conditions such as these, the court is not likely to overrule the decision of the directors.[9]

More frequently, the courts have overruled the payment of dividends because the question of the safety of the principal investment may be raised. Here, the court may feel compelled to conserve the assets in the interest of many parties; at the same time, the element of indiscretion on the part of the directors must be readily apparent.[10] By and large, therefore, "the shareholders' rights to participate in corporate profits is contingent upon the decision of the directors to declare a dividend."[11]

Although the directors ordinarily have rather complete authority to withhold dividends, there are legal restrictions on their right to pay dividends. In general, the directors may not pay dividends when the company is or would become insolvent as the result of such dividends. They are usually required to limit dividends to earnings or earned surplus. In some states, however, surplus created through revaluation of assets may be used. In other states, another exception is that wasting-asset corporations; e.g., mining companies, may declare dividends that are in fact a return of capital. These must be so designated, and suitable reserves must be established to protect the creditors.[12]

TYPES OF DIVIDENDS

Up to this point, we have drawn no careful distinction among the several types of dividends. Dividends may be paid in (1) cash, (2) stock, (3) scrip, and (4) various forms of property. Each of these forms of payment may now be examined in order to indicate their characteristics in relation to financial policy.

Cash Dividends. A cash dividend represents a diminution of the assets of the corporation and an increase of those of the stockholder. In a

[8] Further evidence of the test of reasonableness is shown in *Raynolds* v. *Diamond Mills Paper Co.*, 69 N.J. Eq. 299, 308, 60 A. 491, where it was declared that an equity court "is not without control where the directors roll their profits into their business year after year until the great snowball has been magnified twenty diameters."

[9] In *Stevens* v. *United States Steel Corporation*, 68 N.J. Eq. 373, 59 A. 905, the court would not compel the payment of dividends; here, the surplus was equal to only 6 per cent of the capital stock. Also see *McNab* v. *McNab & Harlin Mfg. Co.*, 62 Hun. 18, 16 N.Y.S. 448, affirmed 133 N.Y. 687, 31 N.E. 627; *Lindgrove* v. *Schulter & Co.*, 256 N.Y. 439, 176 N.E. 832.

[10] See *Liebman* v. *Auto Strop Co.*, 241 N.Y. 427, 150 N.E. 505, where the court refused to restrain the declaration of a dividend.

[11] *Stevens on Corporations*, chap. xii, sec. 99.

[12] *Ibid.*, chap. xii, sec. 100.

highly abstract sense, the increase of assets of the stockholder may not be regarded as genuine, since to the extent he is apparently enriched, the value of his equity in the corporation is diminished. On the other hand, the payment of a cash dividend makes available to the stockholder assets he previously could not touch. In any event, cash is, with few exceptions, the major form of dividend payment.

The payment of a cash dividend involves two separate problems for the financial manager. One is available current earnings or previously accumulated surplus to furnish a basis for the *declaration* of the dividend. The other is a cash position to permit the *payment* of the dividend and still leave sufficient funds to meet the daily requirements of the business. This is not always easy, and it is not unusual for companies with good earnings reports to fail to declare any dividends for the simple reason that the cash position is inadequate when operating requirements are considered.

As an illustration, we might assume the situation of an expanding business which reported earnings of $600,000 for the year and had a balance sheet as follows:

Cash	$ 460,000	Current liabilities	$ 560,000
Other current assets	1,200,000	Capital stock	700,000
Fixed assets	1,400,000	Capital surplus	1,200,000
		Earned surplus	600,000
Total Assets	$3,060,000	Total Liabilities	$3,060,000

It is evident that all of the earnings cannot be paid in dividends, since the earnings are actually invested in all assets. Moreover, the large income in relation to capital and assets would seem to indicate a need for retaining funds in the business. As a consequence, no dividend might be paid. Or the company might declare and pay a dividend of $100,000. This action would reduce the cash by $100,000 and earned surplus by the same amount. Or as a further alternative, the company might declare a stock dividend.

Stock Dividends. Payment of a stock dividend by the assumed company in an amount of $100,000 would serve to increase the capital stock account and reduce the earned surplus by the same amount. In fact, the company could pay any amount of stock dividend up to the amount of its surplus accounts. Cash and other asset items would remain unaffected and fully available for operating purposes. The practice might be followed regularly during periods of expansion or in combination with such cash distributions as circumstances permit. The regular payment of dividends in stock achieves (1) conservation of cash for the company engaging in the practice; (2) a means of raising capital for the corporation; (3) stability of dividends, since the payment in stock does not constitute an immediate drain upon the corporation.

Stock dividends do not alter the cash position of the company and thus

have the same effect as following a policy of retaining all earnings. In either case, the cash is available for operating purposes; and investment has been added to the enterprise from a practical viewpoint. However, stock dividends serve to commit the retained earnings to the business as a part of its fixed capitalization.

The advantage of a stock dividend lies in the fact that it gives the stockholder the choice of increasing his investment in the business or of selling the stock for cash. In other words, he may decide between an increase in his investment or an immediate return in cash. To be sure, if he sells his dividend stock, he is reducing his proportionate equity in the ownership of the corporation and the market value of his holding; but he is given a discretionary choice between retaining the added investment represented by earnings and taking cash, which may well be more important to the stockholder.

Companies differ materially in their stock dividend policies. In the past, stock dividends were usually paid intermittently; any appearance of regularity did not last for long. For example, the Armco Steel Corporation paid a 5 per cent stock dividend in 1918 and 1919, 30 per cent in 1920, 5 per cent each year from 1924 to 1930, and 20 per cent in February, 1948. Remington Rand, Inc., paid a 3 per cent stock dividend in 1927, 2 per cent in 1936 and 1937, $\frac{1}{100}$ share of preferred stock in 1938, and 10 per cent in common stock in 1941. During the years 1944–48, it paid 5 per cent each year. In 1951 and 1952, it again paid 5 per cent in stock. In 1955, the company was merged with Sperry Corporation to form the Sperry Rand Corporation. The new corporation through 1960 had proceeded on the basis of paying cash dividends only.

At the present time, corporations appear to use stock dividends with greater regularity. The greatest use is made during the period of active expansion or rapid growth. The so-called "growth" companies generally follow a policy of no-cash or low-cash dividends accompanied by stock dividends. Such companies contend that the reinvestment of earnings is in the long-term interest of the stockholder. Apparently, the investors agree with this policy; witness, the price-earnings ratios of such companies as International Business Machines which has a low cash pay-out or Litton Industries and Texas Instruments which have used stock dividends exclusively.

Further evidence of investor interest in stock dividends is provided by the experience of Citizens Utilities Company. The expansion of the utility industry has been marked during the past fifteen years. In general, the industry has financed its growth by a balanced offering of bonds and stocks. Dividends have represented a fairly high proportion of earnings. Consequently, internal financing has not bulked as large as in many other lines of industry. The Citizens action in the face of this situation constituted a test of investor interest in the tax advantages of stock dividends *vs* cash

dividends. It also afforded a means of obtaining much more capital from internal sources.

In January, 1956, the management called a special meeting of its stockholders to vote on a reclassification of its common stock into Series A and Series B. Both series would have the same rights, except dividends on Series A would be paid in stock, while dividends on Series B would be paid in cash. Dividends would be properly equated so that neither class would have an advantage over the other. Upon reclassification, stockholders of the old common could select, on a share-for-share basis, whatever proportion of each new class they desired. They could take all in Series A or Series B, or part of their holding in both series. Thus they could determine how much dividends in cash they wanted, and what proportion in stock.

The plan provided furthermore that in the future Series A stock could always be converted into Series B stock except during the period between the time cash dividends were declared and paid on the B stock. The company advised that the Treasury had ruled in effect that the exchange of the existing stock into either Series A or Series B would be tax-exempt. Further conversions of Series A stock into Series B stock likewise would be exempt.

The company in its advocacy of the plan stated that it estimated that it would save around $6,000,000 in cash over a ten-year period, for expansion and other company uses, as well as create a stock equity which would permit bond financing to the extent of $12,000,000 to $14,000,000. On January 30, 1956, the stockholders approved the program. Subsequently, 75 per cent converted their holdings into Series A, the class of stock which would receive dividends in stock.

Whether the plan inaugurated by Citizens Utilities Company would be followed by other companies remained a question after its successful consummation. It developed that the favorable ruling covering the tax-exempt phase of the exchange of stocks was issued by the Internal Revenue Bureau. Upon review the Treasury Department questioned the propriety of the ruling. While even a negative approach in the future would probably not disturb the Citizens Utilities plan, it certainly could prevent other companies from adopting the same plan.

The Citizens Utilities case represents an interesting innovation in retaining cash in that it gives stockholders a direct voice in the matter. At this point, however, our interest is in the dividend policy rather than in the raising of capital. Regardless of whether stock dividends or stock rights are employed to raise capital, increased earnings are essential to support the expanded capitalization. The rights plan imposes a more immediate need for earnings to defray larger cash dividends and therefore is more apt to affect the cash position of the company. The stock dividend plan also increases the demand upon earnings but not as suddenly; instead

it helps to preserve the cash position of the company for the time being.

The potentialities of an annual stock dividend policy are so startling as to invite inquiry as to whether or not it could be conducted perpetually. Obviously, no cash would ever be paid to the shareholders by the corporation; and the only outlet for such realization would be through sale in the market. Hence, the ultimate test of the propriety or soundness of the policy would be found in market response. As long as the corporation continues to expand at a profitable rate, the policy may well receive support. Conversely, declining earnings and general business recession would serve to retard its acceptance. Broadly speaking, the continuance of stock dividends as a substitute for cash dividends beyond the stage of profitable expansion would be likely to prove undesirable to both the corporation and the stockholder.

It cannot be emphasized too strongly that the policy of paying regular stock dividends instead of cash is purely temporary and cannot be considered as a permanent replacement. To focus the ultimate effect, suppose that all corporations pursued this course. Any investor committing his funds largely to stocks of this class would of necessity have to sell his dividend stock to achieve a real income. As stated above, this would be feasible only as long as the market response was favorable. Stock dividends of this type are also fatal to the stockholder in the event of failure, since it means that he may lose not only his initial investment but, in addition, dividends that he might otherwise have received in cash. Because of these unusual characteristics, the adoption of a policy of paying dividends in stock in lieu of cash is the decided exception.

Recurring or regular stock dividends are usually small in amount ranging from 2 per cent to perhaps as much as 10 per cent. Such amounts bear some relationship to the current pattern of earnings and have little or no perceptible effect on the market quotations of the stock. In addition, much larger and more spasmodic distributions occur. Such dividends may amount to as much as 100 per cent of the outstanding stock and occasionally are even larger. The large distributions always result in appropriately lower prices of the stock. The day a stock sells "ex" a 100 per cent dividend it will show approximately a 50 per cent decline in price. Thus the stockholder has twice as many shares worth about the same value on the market as the day before the distribution became effective.

Stock dividends are usually regarded in the speculative market as melons, i.e., the division of accumulated surplus. As indicated above, however, the stock dividend simply divides the same amount of wealth into a larger number of aliquot parts. No increment of wealth is added, nor is any distribution actually made to stockholders. In the face of these facts, stock dividends are accepted with enthusiasm because of the following considerations:

1. A stock dividend is a public admission of a large accumulated surplus.

2. It is regarded as being probable that a higher pro-rata rate of dividends will be declared on the new shares.

3. The stock dividend lowers the price of the stock and consequently enlarges the market for the stock. For the more immediate reaction, it is found that stocks usually have a rapid rise prior to the declaration, with a tendency toward dullness after the dividend is issued.

Before leaving the subject of stock dividends, it might be well to draw a distinction between stock dividends and stock splits. As explained earlier, a stock dividend increases the number of shares of stock outstanding by transferring surplus to the capital stock account, i.e., by "capitalizing" it. A stock split increases the number of shares of stock outstanding, but it need have no effect on the total amount shown as capital stock. Thus, on September 30, 1955, General Motors Corporation split is common stock 3 for 1; that is, it called in its $5.00 par common and issued three shares of $1.66⅔ par common for each share of old common outstanding. Each stockholder then owned three times as many shares but only the same percentage of common outstanding. The capital stock account continued to show the same dollar amount.

Scrip Dividends. A third type of dividends utilized by corporations is scrip, which is a form of promissory note promising to pay the holder at a specified later date. Such certificates are usually interest-bearing and are frequently acceptable as collateral. They may be utilized either when a corporation is immediately short of cash or when it desires to conserve its present cash holdings for other more pressing demands. As an instance of their use, the American Tobacco Company paid its dividends in this form for six quarters during 1919 and 1920. Later, instead of liquidating these obligations in cash, it succeeded in retiring the scrip by exchanging common B stock. Ordinarily, a scrip dividend is a substitute for cash; but in this case, it proved a temporary medium for stock dividends. Scrip dividends have the effect of creating a current liability on the balance sheet and reducing the surplus account. Stockholders holding scrip dividends are in the same position as general creditors of the company and can bring action to collect their claims if necessary.

Property Dividends. Finally, dividends may occasionally be paid in the form of property or in some asset other than cash. These distributions are usually the result of exceptional conditions and are not apt to represent normal policy. The following conditions are illustrative of their past use:

1. When breweries were ruled illegal through the application of the Volstead Act, the stocks of liquor on hand could not be disposed of through normal sales channels. Hence, they were used for distribution to the stockholders.

2. After World War I, many corporations and individuals held large amounts of Liberty bonds. In a few cases, the former distributed the bonds as dividends.

3. In closed corporations, it is common for the owners to utilize the products produced if at all adaptable to family life.

4. Corporations holding stocks of other corporations (usually subsidiary or having a common interest) sometimes distribute these shares to their stockholders as a means of avoiding actual or possible prosecution under the Sherman Antitrust Act or for reasons not usually made public. Examples are the distribution of stock of Electric Bond and Share Company by General Electric Company, of stock in Radio Corporation of America by General Electric Company and Westinghouse Electric Corporation, of stock in Mission Corporation by Standard Oil Company of New Jersey, etc. The most important illustration is the distribution of stock by public-utility holding companies to comply with the Public Utility Holding Company Act of 1935 (see Chapter 29).

LIQUIDATION AND INCOME DIVIDENDS

As a final classification of dividends, it is necessary to distinguish between liquidation and income dividends. The latter are the normal expectancy of all going concerns and are presumably covered by current, or at least accumulated, earnings. Liquidation dividends represent the distribution of assets either as a result of failure or as a result of dissolution for other reasons.

SUMMARY OF PRINCIPLES UNDERLYING DIVIDEND POLICY

With the foregoing discussions in mind, certain principles underlying dividend policy may be set forth:

1. Dividends should be regular in preference to irregular. This is accepted as desirable for the corporation's credit standing and for the stockholders' welfare. However, this "regular" dividend should be established at a level sufficiently low to be earned in all but the very worst years.

2. High earnings may be used to pay extra dividends; but such dividend distributions should be designated as "extra," and care should be taken to avoid the impression that the regular dividend rate is being increased.

3. If the earnings position is sound but current conditions make it desirable to conserve cash, scrip dividends may be resorted to for purposes of meeting temporary conditions.

4. Regular stock dividends may be used where concerns are expanding and can profitably employ the capital retained.

5. Large, irregular stock dividends should be used only occasionally—and even then with discretion. The purpose should be strictly to accomplish the permanent retention of capital in the business and not to influence speculative proceedings in any way.

QUESTIONS AND PROBLEMS

1. Comment on the dividend policies of the Capital Transit Company while under the control of the Wolfson interests.
2. Discuss the relationship between dividend policies and the raising of capital (*a*) by the retention of earnings and (*b*) by the sale of securities.
3. Discuss the relationship between dividend policies and changing price levels. (See Harvey M. Spear, "Dividend Policies under Changing Price Levels," *Harvard Business Review,* Vol. XXVII, No. 5 [September, 1949].)
4. Is it sound policy, in your opinion, for the Radio Corporation of America to withhold dividends in order to conserve the funds for purposes of expansion in the field of electronic computers?
5. Why is there less need for the declaration of a formal dividend policy in the case of smaller companies?
6. "In many respects, there is more likelihood of the abuse of minority interests in the case of small companies than of large companies." Discuss.
7. In the case of *Dodge* v. *Ford Motor Company,* the defendant contended that the withholding of dividends was in the interest of the larger public welfare and would permit increased employment as well as the production of cars at a lower price. Do you think this position consistent (*a*) with the law and (*b*) with sound economics?
8. Discuss the merits of periodic stock dividends. (See Joseph C. Bothwell, Jr., "Periodic Stock Dividends," *Harvard Business Review,* Vol. XXVIII, No. 1 [January, 1950].)
9. Distinguish between the use of stock dividends and stock splitting as a means of bringing the market price of an existing issue to a lower level.
10. Discuss the relative advantages and disadvantages of regular dividend payments as compared with a policy that relates dividends more closely with earnings.
11. Make a comparative analysis of the dividend policies of the Acme Steel Company and the Armco Steel Corporation. To what extent do the two policies reflect differing operating situations? Could either company have adopted the dividend policy of the other?
12. Study market prices of dividend and nondividend common stocks to determine the effect of dividend policy upon investor preference as evidenced by market quotations.
13. Investigate the stock market effects of the 100 per cent stock dividends paid by American Cyanamid in 1951 and 1957. Were the results beneficial to the stockholders? Why or why not?

REFERENCES

Bosland, Chelcie C. *Corporate Finance and Regulation,* chap. xiii. New York: The Ronald Press Company, 1949.

Buchanan, N. S. *The Economics of Corporate Enterprise,* chap. ix. New York: Henry Holt & Co., Inc., 1940.

Burtchett, Floyd F., and Hicks, Clifford M. *Corporation Finance,* chap. xxxi. 3d ed. Lincoln, Nebraska: Johnsen Publishing Co., 1959.

Dewing, A. S. *Financial Policy of Corporations,* chap. xx. New York: The Ronald Press Co., 1953.

GERSTENBERG, CHARLES W. *Financial Organization and Management*, chap. viii. 4th rev. ed. Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1959.

OSBORN, RICHARDS C. *Corporation Finance*, chap. xx. New York: Harper & Brothers, 1959.

SMITH, DAN THROOP. *Effects of Taxation: Corporate Financial Policy*. Cambridge: Harvard University, 1952.

Stevens on Corporations, chap. xii. St. Paul: West Publishing Co., 1936.

Chapter 25 ►

RETAINED INCOME AND RESERVES

NET INCOME remaining from current operations after deduction of all appropriate expenses and charges is transferred to an account that traditionally has been termed "surplus." The term "surplus" or "earned surplus" is an accounting phrase. It was not used to indicate excessive earnings, or an excess of assets not needed in the business. On the contrary, it was intended generally to indicate reinvestment in the business of surplus earnings in excess of dividend requirements, or a surplus capital investment over and above the legal capitalization. It differed from capitalization as evidenced by capital stock in that it could be withdrawn from the corporation at the discretion of the directors. Capital stock, on the other hand, is usually retired only through the liquidation of the company. Of course, the liquidation may be only partial, as is the case when a company advertises for tenders of definite amounts of its stock or, as a result of reorganization, a company distributes part of its assets and reduces its capital stock by action of the stockholders.

In the past few years, there has been a trend away from the use of the term "surplus."[1] With the constantly widening public interest in corporate affairs has come a need (and a demand) for more descriptive accounting terminology. Too many people have thought of surplus in terms of excess cash or have failed to appreciate the financial significance of retained income. In an effort to make balance sheets more understandable, it is becoming more common to use language denoting the source from which the equity capital has been derived. Illustrative of such terms are the following: earnings reinvested, earnings retained and in use in the business, accumulated earnings, retained income or net income retained for use in the business. Although such traditionalists as Allied Chemical Corporation and E. I. du Pont de Nemours & Company continue to use

[1] American Institute of Accountants, *Discontinuance of the Term Surplus* (Accounting Research Bulletin No. 39 [October, 1949]). See also by the same organization *Accounting Annual Reports*, 6th ed.; November, 1952, and 9th ed.; November, 1955.

the term "earned surplus" they are in a decreasing minority of companies using this term. More indicative of the modern trend is the 1960 *Annual Report* of General Motors Corporation which shows: "net income retained for use in the business (earned surplus), $4,443,807,729." Ford Motor Company, a newcomer to the list of publicly owned companies, in 1960 reported: "consolidated statement of earnings for use in the business: $2,316,184,292." Even tradition-respecting United States Steel Corporation follows the new terminology, and its 1960 *Annual Report* shows (as have recent reports): "income reinvested in business, $2,041,031,287." Although it would appear that the majority of corporations have adopted the more modern and descriptive terminology, its use is not convenient for discussion purposes. As a consequence we have used the more facile term (when understood) "surplus," except when the published reports have followed the new terminology.

SIGNIFICANCE OF SURPLUS AS EQUITY

There is need to reiterate that surplus is solely an equity of the stockholders and is not an asset in any sense of the word. Neither may the assets arising from this source be segregated or earmarked as being representative of the surplus account. Profits affect the business enterprise as a whole, and the increment of assets which comes from successful operation is more or less automatically distributed among all the various asset accounts. It is true that earnings serve initially to increase the current assets (cash, accounts receivable, inventories, etc.); but there may be diversion also into plant and other long-term improvements by action of the management. There is a great deal of truth in the saying, "You can't tag a dollar"; that is to say, once money goes into a business, the identity of its source is lost.

Such an understanding of surplus is essential for the proper formulation of financial policy. It means that surplus itself does not fully inform the directors of the financial position of the company, of the results of operation, or whether or not dividend payments are economically sound. Equally important, the state of the assets must also be given consideration. Although the accumulating surplus may have resulted in additional assets, they may not be available for immediate dividend payments. A change in the rate of the turnover of working capital may mean a reduction in cash and an increase in accounts receivable, inventories, or goods in process. Under these circumstances, a more conservative dividend policy may be desirable. Moreover, it is necessary to consider the accounting methods employed before it is possible to say that the profits indicated have actually been realized. Calculated depreciation may be inadequate, and hidden losses may be contained in accounts receivable and in inventories.

It is not unusual for a corporation to fail and yet have a reasonably

large balance appearing in the surplus account. This happens when poor financial management or the pressure of economic events results in a lack of liquid assets with which to pay currently maturing obligations. Under such circumstances, any creditor holding a past-due debt can bring receivership action.

To repeat for the sake of emphasis, the following observations concerning the nature of surplus may be stated succinctly:

1. The surplus account is not offset by any specific assets but simply represents an equity of the stockholders in the assets as a whole.
2. A large surplus account may not necessarily mean a satisfactory financial position.
3. A surplus account does not necessarily mean that assets are in excess of current needs as of a given year; primarily, it reflects the growth of the stockholders' equity.

NEED FOR RETAINING SURPLUS

With this understanding of surplus, consideration may now be given to the various questions of corporate policy relating to the retention of income. Why should corporations retain a portion of net income in the business rather than distribute the excess earnings to the stockholders? The general answer to this query is obvious, but much may be gained by answering it as completely as possible. The practice may be analyzed from at least three points of view: (1) corporate management, (2) the investor, and (3) public welfare.

SURPLUS AND THE CORPORATION

One of the basic aims of progressive management is to make the corporation as enduring as possible. It should be able to withstand seasonal reactions, the shock of business depressions, and the vicissitudes of broad social movements. An important means of attaining this position is the accumulation of surplus. This is true because, first, the presence of a relatively large and sound surplus account adds greatly to the credit position. The growing surplus account is usually taken as an indication of progress, which increases the amount of the residual equity and helps to make the company a good credit risk. Second, a stable dividend policy is facilitated by a large surplus because the company is less dependent upon the results of any one year (assuming that a satisfactory current asset position will permit the payment of dividends). The combination of a good credit rating and an established dividend record affords great relief against business depressions, since an assured credit position aids in obtaining liquid funds to meet current financial needs; and an established dividend policy adds general stability by enlisting the support of the stockholders.

The surplus account is also a source of capital for expansion purposes, and its use is sometimes referred to as the "plowing-in" of surplus. Normally, the earnings of any given period are realized at some time in the form of cash or relatively liquid funds. Management has a choice of paying out dividends to the extent of its accumulated earnings, assuming that the cash position will permit, or of keeping a portion of the earnings in the business. While the retention of a portion of the earnings in the business may not represent any sizable amount of additional capital in a given year, the accumulation may be quite important over a longer period of time. Plowed-back surplus will frequently provide more additional capital than is obtained through the sale of new securities. Also, funds raised in this manner may be used to retire bonded indebtedness to the end of having a company free of long-term debt.

Since surplus lacks the fanfare of a new security issue, its importance as a source of capital is not commonly appreciated. Yet it is not unusual to find the surplus account in excess of either preferred stock or funded debt. Again, many smaller enterprises rely almost entirely upon common stock and the retention of earnings as sources of long-term capital. Taking a broad cross section of manufacturing business enterprise, the various classifications of earned surplus were found to amount to over $97,102,000,000, or 38.1 per cent of the total assets based on data derived from a continuing study by the Federal Trade Commission and the Securities and Exchange Commission.[2] These data were based on the account classifications used in balance sheets of the reporting companies and are by no means conclusive as to the importance of surplus as a source of capital. Amounts carried in a surplus category at one time may be capitalized through stock dividends at a later date. Yet surplus or retained earnings would still be the true source of the capital. Perhaps a more accurate measure of the importance of retained earnings is the fact that, in the period 1939–60, corporations as a group retained nearly $178 billion out of net profits after taxes. Of considerable significance is the fact that $116 billion of this sum were added to surplus in the twelve years 1949–60. It is highly unlikely that this sum could have been raised through the sale of new equity securities.

SURPLUS AND THE STOCKHOLDER

Broadly speaking, anything that improves the position of the corporation must favorably affect the welfare of the stockholder. Exception may be taken to this statement because it is conceivable that inside interests could retain earnings to the point that dividend prospects would be extremely remote. Dividends would be deferred beyond a reasonable wait-

[2] Federal Trade Commission and Securities and Exchange Commission, *Quarterly Financial Report for Manufacturing Corporations, Fourth Quarter, 1960* (Washington, D.C.: U.S. Government Printing Office, April, 1961).

ing period, and stockholders in need of funds would be forced to liquidate their investment. However, such conditions are decidedly abnormal; and stockholders themselves usually favor a reasonable accumulation of surplus for the following reasons: (1) greater assurance is provided against failure; and, more important, (2) the investment frequently proves to be very profitable. The retention of surplus by a corporation is an act of trust performance, i.e., in the social implications of the term. In the first place, the decision is made to retain earnings that otherwise may be distributed as dividends. Secondly, this should be done only if it makes the stockholders' position more secure and obtains reasonable profits upon the additional investment. Irrespective of the outcome, it is clear that the retention of earnings gives rise to a form of involuntary investment by the stockholders. This right of decision is usually accepted as an ordinary prerogative of management; and in addition, it has the support of legal sanction. At the same time, there is danger in carrying this power to the point of an assumed privilege of management without proper regard for the effects on both investors and society. Certainly the stresses and strains of the past twenty-five years have made it clear that the investment of surplus earnings should be checked just as carefully as funds coming from the open market.

In analyzing financial practices, there is an inclination to probe for the underlying principles of a more or less ideological character. Often, the facts run counter to these theoretical concepts—not because the latter are unsound but because powerful forces of expediency compel their violation. It is true that surplus is accumulated to provide a cushion of safety and to take advantage of profitable investment; but probably more important, surplus is frequently the only convenient source of new capital. Irrespective of safety and profits, the momentum of a going concern requires the infusion of new funds for meeting the fluctuations of business as well as for purposes of normal expansion. Also, smaller companies with less access to the open market will raise a larger proportion of their capital from the retention of earnings than larger companies which can attract capital by the sale of new securities.

Another illustration of the effect of expediency on financial practice is found in noting the relationship between funded debt and surplus. It might be expected that companies that utilize funded debt as a means of raising capital would accumulate surplus as a means of providing a better equity position for borrowing purposes. Actually, a cross section of industry shows the opposite condition and indicates that companies with only common stock outstanding have made greater use of surplus.

These are facts that stockholders need to face realistically. They may be told that the surplus will make the company safer or that the reinvestment of earnings will add to the profitability of their investment, but the plain truth is that needed capital often cannot be raised conveniently by any other means. And, as stated earlier, the most important criterion by

which to judge the policy of surplus accumulation is to be found in the results obtained from the investment of the funds, i.e., on the asset side. In many respects, the ratio of surplus to total capital or to the total assets is mainly a financial decoration; the realities are found only in cold-blooded analysis of the asset structure.

SOCIETY AND CORPORATE SURPLUS

Not only are the corporation and its stockholders directly benefited by a sound surplus policy, but there is also a contribution to the welfare of society. It is an act of saving which facilitates the storing of wealth necessary to social progress. This may not be the intent of corporate management, but such must be the result to justify the accumulation. Surplus should facilitate the improvement of plant and encourage the adoption of technical advances so that goods of better quality are produced at lower prices. By this means, society at large should be the beneficiary of an increased standard of living.

The existence of a sound surplus position may also prove to be a public benefit by its absorption of the shocks of business depression. Where the account is not large enough to absorb losses, there is an impairment of the capital account which often leads to failure. The charging of losses to surplus is purely a bookkeeping transaction, but it may be of importance in avoiding legal and financial embarrassment. Without this cushion, banks and other financial institutions may be taken over by supervisory authorities because of their impaired condition. Ordinary industrial companies with a deficit may continue to operate if they are still able to pay their debts, but there may be great difficulty in securing credit and in maintaining the good will of the stockholders. Hence, by avoiding failure and other financial embarrassment, surplus is a factor in relieving society from possible confusion and disorganization.

It should be emphasized that the presence of a large surplus account is a protection against technical insolvency only, i.e., against an impairment of capital. A corporation can be insolvent in this sense and still operate as long as it meets its maturing obligations. If the surplus is to assist in maintaining financial stability, it is necessary for the assets to be managed so as to assure sufficient current funds for meeting all obligations as they fall due. It is possible for a company having a minimum capital position to do this, but the presence of a substantial surplus will assist in the process by furnishing a greater measure of flexibility.

Consideration should be given to the theory that the enlargement of surplus tends to produce and intensify the baneful effects of a depression. It is contended that corporate savings generate a lack of balance between purchasing power and production by diminishing the former and increasing the latter. The validity of the arguments depends upon the interpretation of the term "purchasing power." In the sense that it is the

equivalent of the very goods and services produced, the argument is obviously fallacious. Others regard purchasing power as a separate phenomenon, and the assumption of this connotation lends merit to the view that large corporate savings tend to produce a state of overproduction. At the same time, it does not dispose of one other significant aspect of the case, viz., that savings are essential to the growth of industry. It also follows that improvements of the standard of living must necessarily be dependent upon an increase in the supply of goods, which is forthcoming only through the enlargement and improvement of industrial plant and facilities. Thus, it would appear that corporate savings, at least at a reasonable rate of increase, tend in the long run to help society.

EXTENT TO WHICH CORPORATIONS RETAIN SURPLUS

Corporations vary greatly in their practice of retaining surplus. Some are inclined to keep as large a portion in the business as possible, whereas

TABLE 49

UNDISTRIBUTED CORPORATE PROFITS, ALL INDUSTRIES, 1929–60*
(000,000 Omitted)

Year	Undistributed Balance after Payment of Dividend	Amount by which Distribution Exceeds Profits
1929	$ 2,466	
1930–38		$20,186
1939–46	36,656	
1947	11,721	
1948	13,274	
1949	8,532	
1950	13,555	
1951	10,677	
1952	8,278	
1953	8,864	
1954	7,002	
1955	11,820	
1956	11,324	
1957	9,698	
1958	6,720	
1959	10,462	
1960 (est.)	9,000	
Total corporate savings	$180,049	
Total corporate dissavings		$20,186
Net corporate savings	$159,863	

* U.S. Department of Commerce.

others are more liberal in their dividend payments. Although it is generally accepted as a desirable policy to provide for regular dividend pay-

ments irrespective of fluctuations in profits, some companies are unable to do this and pay dividends only as current profits permit.

An example of policy in the retention of surplus is that of the General Motors Corporation, which had retained from the date of its organization to the end of 1960 a total of $4,623,268,000 out of its net earnings. During the same period, a total of about $8 billion was paid to the common stockholders in cash dividends. The dividend record is most impressive, the disbursements representing more than a ninefold return of the present amount of capital stock. At the same time, the importance of earnings as a source of capital must also be recognized because the net income retained for use in the business (earned surplus) still on the books amounts to $4,443,807,729. This compares with common stock outstanding in the amount of $474,556,358 and preferred stock of $283,564,400.

Table 49 (p. 501) shows the extent to which corporations in the aggregate retained surplus over and above dividend payments in some years and paid out more than was earned in other years. In the twenty-seven-year period, gross retentions (savings) amounted to $180,049 million; whereas dividend payments in excess of earnings (dissavings) equaled $20,186 million. The net savings of corporations were equal to the sizable sum of $159,863 million.

EFFECT OF CORPORATE SIZE ON THE RETENTION OF SURPLUS

Although the total volume of retained surplus is important to the economy, the variations that exist in practice are more important in the formation of financial policy. Since one reason for retaining surplus is to finance expansion, we should expect a tendency to retain surplus in proportion to the firm's inability to obtain funds from other sources. Small corporations do not have access to the security markets on any reasonable basis. As a result, they must obtain their equity capital from limited local sources and from earnings. Practically speaking, this means that most expansion must be financed from earnings.

Table 50 shows the percentage of earnings retained by corporations in the period 1931–41, and for the years 1945, 1952, and 1957, classified by size of corporation. The extent to which the smaller corporations retained earnings in comparison with the larger corporations is most striking. The greater retention in the last three years shown as compared with the earlier period was a reflection of the times, rising prices, large volume of business, and the attendant need for working capital. Although much of this variation in practice was due to the need for additional capital, other influences should be mentioned. One is the fact that small concerns are usually closely held, and the important stockholders are frequently in a position to draw off earnings through the salary account. Another influence is the relatively greater importance of capital assets in the operations of large companies, which results in depreciation and depletion

charges being a far more important source of funds for large companies than for small ones. These funds are, of course, available for rearrangement, new-product development, and similar purposes.

The importance of a company's ability to retain earnings may be illustrated by the Ford Motor Company, which grew from an original investment of $28,000 to over $2,316,000,000 without further outside investment. This is an extreme case; but retained earnings have been a very important, if not the most important, source of funds for financing the

TABLE 50

PERCENTAGE RETENTION OF NET PROFITS AFTER TAXES OF CORPORATIONS WITH NET PROFITS, 1931–41, 1945, 1952, AND 1957

Asset Size	Percentage			
	1931–41*	1945†	1952†	1957†
Under $50,000	53.1	82.4	82.1	57.6
$50,000–$100,000	51.1	80.3	82.1	61.5
$100,000–$250,000	46.3	75.0	76.6	75.0
$250,000–$500,000	41.6	69.2	70.4	67.2
$500,000–$1,000,000	38.1	74.0	64.2	70.6
$1,000,000–$5,000,000	32.3	57.7	56.7	65.5
$5,000,000–$10,000,000	27.2	49.2	49.7	58.9
$10,000,000–$50,000,000	17.3	42.4	38.9	49.7
$50,000,000 and above	12.6	38.0	33.2	36.0
All classes	21.2	48.8	41.9	44.3

* E. B. George and R. J. Landrey, "The Shadow of 102 on Dividend Policies," a supplement to *Dun's Review*, 1947, p. 27.

† Computed by the authors from Bureau of Internal Revenue, *Statistics of Income for 1945, 1952, and 1957*. Part II (Washington, D.C.: U.S. Government Printing Office, 1950, 1955, and 1959).

growth of nearly all industrial corporations. Whether or not retained earnings will play an equally important part in future corporate growth will depend in substantial measure upon the level of corporate taxation.

ADMINISTRATION OF THE INCOME RETAINED

When income is retained in the business, the question arises as to its use and disposal. It is necessary in this connection to keep in mind the relationship between surplus as an equity account and the various counter-balancing assets. From the point of view of the assets, it may be said that surplus earnings may be used either for the improvement of the working capital position or the increase of the fixed investment. As previously emphasized, it is impossible to designate specific assets as coming from earnings, thereby making it difficult to determine whether surplus has been used to improve the working capital position or to add to the fixed investments. At the same time, it is possible to secure a degree of correlation between the asset outlet and the equity source by the use of appropriated surplus accounts, which are more generally referred to as "reserve" accounts.

Unappropriated surplus is simply the total of the accumulated earnings allowed to remain in the business, which are not designated for any particular purpose. Frequently, it is desirable to align surplus with some specific program; and a portion of the surplus is definitely tagged as being for that objective. This may be made clear by reference to Table 51, showing the summary balance sheet of the United States Steel Corporation, which is an example of a company making rather extensive use of reserve accounts.

Reference to Table 51 shows that unappropriated surplus, termed "income reinvested in business," amounted to $2,041,031,287, while reserves for insurance, contingencies, accident and hospital expenses totaled $114,-

TABLE 51

UNITED STATES STEEL CORPORATION
SUMMARY BALANCE SHEET
December 31, 1960

ASSETS	
Plant and equipment (less depreciation)	$2,787,553,310
Deferred charges and miscellaneous investments*	94,554,802
U.S. Government securities at cost set aside for property additions and replacements	300,000,000
Current assets*	1,395,842,376
Other assets*	48,898,855
Total	$4,626,849,343
CAPITAL AND LIABILITIES	
Common stock	$ 900,555,117
Preferred stock	360,281,100
Long-term debt	422,778,670
Current liabilities	787,747,771
Insurance reserves	50,000,000
Reserve for contingencies	55,001,172
Reserve for accident and hospital expenses	9,454,226
Income reinvested in business	2,041,031,287
Total	$4,626,849,343

* Net after reserves.

454,498. In addition there were reserves amounting to $18,229,708 deducted from "other assets." The company's annual statement showed that, during the year, the amounts credited to the insurance and accident reserves from income were equal to the charges. The reserve for contingencies was credited $1,727,500.

It should be understood that allocations from the surplus account proper to the reserve accounts do not necessarily affect the distribution of the assets except to assure their retention in the business to a greater degree. However, the allocation of surplus for specific purposes should imply definite needs which would reduce the amount of surplus available for the declaration of dividends and serve to restrict the disbursement of cash necessary for this purpose.

Occasionally, companies establish separate funds at the same time they set up reserves. Although the term "funds" is used loosely in practice and may appear on the liability side in the sense of a reserve, it is more accurate to restrict the connotation to asset allocations. In this sense, there is usually an actual segregation of cash for definite uses. The creation of separate and special asset funds is not a common practice because of the greater convenience and profitability in keeping all funds available for general purposes. It is true that special funds which are created voluntarily may be discontinued at the discretion of the board of directors, but there is danger that such action may be interpreted by outsiders as a vacillating and unsatisfactory policy.

Even though reserve accounts (as distinguished from funds) do not directly isolate assets for the specific purposes designated, their function still remains. This may be seen by relating financial policy to the following main classifications or types of reserve accounts: (1) valuation reserve accounts, (2) proprietary reserve accounts, and (3) liability reserve accounts.

VALUATION RESERVE ACCOUNTS

A valuation reserve is usually a "contra" account to some asset. It is best represented by the reserve for depreciation and by the reserve for bad debts. For example, if the plant account of the Makup Company is reported as $1,500,000 and the reserve for depreciation as $450,000, the present book value of the plant is computed as follows:

Original cost of plant	$1,500,000
Less: Reserve for depreciation	450,000
Present book value	$1,050,000

It is apparent that the major purpose of such a reserve is to replace or supplant the value that is departing from the original investment. Certainly, before any business enterprise can say that it has a net profit (in the ultimate sense of the term), it must provide for depreciation of its plant, equipment, and other wasting assets.

In periods of depression, there is a tendency to minimize the pertinency of depreciation cost. Either the charge is reduced; or, occasionally, it may be eliminated. The latter is technically accomplished by writing the value of the plant down to $1.00 and charging the surplus account (assuming that the account is large enough to absorb the charge) for the write-off. An illustration of this is the case of the May Department Stores Company, which, in 1933, reduced the depreciated book values of its furniture, fixtures, and equipment and delivery equipment accounts to $1.00 each, and charged surplus. From January 31, 1933, to January 1, 1943, the company followed the policy of charging all purchases of such equipment to expense. On January 1, 1943, it returned to the former and

more usual practice of capitalizing additions to fixed assets and depreciating them over their useful life. Furniture, fixtures, and delivery equipment were re-established on the books at $5,057,257 (i.e., cost of $11,-690,100 less reserves for depreciation of $6,632,843); and surplus was credited with this amount.

It is evident that the policy of writing down the assets in 1933 had the effect of increasing apparent earnings. Likewise, it was abandoned in 1943 when changes in the economic and tax environment made the policy have an adverse effect on earnings. Actually, reported earnings were increased by $1,462,175 during the eleven-year period because of this policy.[3] It is doubtful if so extreme a policy is being followed by any important corporations today. Certainly, it would be frowned upon by regulatory bodies and the accounting profession.

When the fixed investment is written off, it is commonly assumed that prices may be lowered and competition more easily met because of the elimination of the depreciation charge. From the accounting point of view, this may be true; but it is not easily defended in terms of financial management. Viewed from the perspective of the latter, one of the chief objectives of management is to preserve the enterprise as a going concern. In this light, it will be observed that to write off the value of the plant is simply an act of recognizing a loss and does not contribute to the permanency of the organization the management represents.

The removal of any basis for a depreciation charge would increase the paper net profits which would be reported to the stockholders in the future; but, at the same time, it is clear that the gradual accumulation of assets normally resulting from the depreciation charge would be eliminated. Consequently, if management should pay out the bulk of the apparent profits as dividends, it may in reality be sacrificing the recurring nutrition of plant which is necessary to keep a business in vigorous condition. After a few years of this policy, the assets would become exhausted; and the company would no longer be able to operate. This could be avoided by a judicious surplus policy wherein surplus was increased each year by an amount equal to depreciation. However, this could be more readily achieved by systematically charging depreciation based upon the current value of the physical assets used in the business. In other words, it may be said that management may regard depreciation in terms of the replacement of values rather than merely accounting for the investment originally committed to its care. While this is the equivalent of new investment, it is probable that the stockholders are much better protected by such a method. As a matter of fact certain companies follow this theory in practice to offset the spiraling costs of replacement of assets. In addition to the regular depreciation charge, they set aside an additional reserve out of current income (after computation of regular net income)

[3] *Moody's Manual of Industrials, 1950*, p. 2398.

to serve as a sort of replacement fund for the cost of replaced equipment over and above its original cost.

As an illustration of the philosophy of no reserves for depreciation of assets, some mention may be made of the railroad field, where no depreciation charge is made to cover the plant (not including equipment). It is contended, and with much logic, that normal replacement and maintenance automatically preserve the original status of the investment. Through the continuous replacement of worn-out ties and track, it would seem that the road should retain its original capacity for operation. This theory, however, stresses unduly the engineering or technical aspects of depreciation and attaches too little significance to changes in value which arise from other sources. It does not provide for obsolescence or for changes that may be desirable to lower the cost of operation. This failure to charge depreciation looks too much in the direction of the past and pays too little heed to what may possibly be ahead.

The nature of depreciation and other valuation reserves, such as the reserve for bad debts, differs fundamentally from the proprietary reserve accounts, which are in reality elements of "tabbed" surplus. The former constitute a legitimate charge against operating income, whereas the latter are the outgrowth of net income and its later accumulation. This may be seen to better advantage by a consideration of the more representative types of proprietary reserves.

PROPRIETARY RESERVE ACCOUNTS

There are a multitude of proprietary reserve accounts, but consideration will be given only to those accounts which are common expressions of financial policy. The following may be analyzed in order: (1) reserve for improvements, (2) reserve for contingencies, (3) sinking fund reserves, (4) reserve for insurance, (5) reserve for dividends, and (6) reserve for working capital. During the war and the immediate postwar years, a new reserve account appeared in corporation balance sheets. This was frequently termed "reserve for reconversion expense." Although it rose out of a special situation, its purpose was essentially the same as a reserve for improvements and need receive no special discussion here.

Just as valuation reserves are used to give formal recognition to expenses that cannot be determined accurately, so proprietary reserves are used to recognize elements of financial policy. Surplus is available for the declaration of dividends and, if large, may lead to stockholder pressure to do so; but in terms of management thinking, the surplus may not exist. Perhaps it has been retained to finance a current expansion in operations which has demanded additional assets in all categories. Or it may be that future prospects involve some contingencies against which provision should be made. Whatever the reason for the action, any appropriation of surplus to a proprietary reserve serves both as an announcement of

policy and as a temporary removal of surplus from availability for the declaration of dividends.

Reserve for Improvements. The purpose of the reserve for improvements is to tap the surplus account for a specified amount of improvements. It may also be designated as a reserve for additions and construction or other similar terminology may be used.

The creation of the reserve for improvements is accomplished by transferring a similar amount from the surplus. No new assets are obtained by setting up the reserve; and, hence, it in no way assists in the immediate financing of construction activities. Indeed, it may be created after the means of making the improvements have actually been assembled. This may be made more concrete by the following assumed example:

BALANCE SHEET OF THE MAKUP CORPORATION, DECEMBER 31, 1955

ASSETS		LIABILITIES	
Current assets	$2,000,000	Current liabilities	$ 700,000
Fixed assets	2,400,000	Bonds	1,000,000
		Capital stock	2,700,000
	$4,400,000		$4,400,000

At the end of December 31, 1960, the following condition is assumed:

ASSETS			LIABILITIES	
Current assets		$4,000,000	Current liabilities	$1,000,000
Fixed assets	$2,400,000		Bonds	500,000
Less: Depreciation reserve	400,000	2,000,000	Capital stock	2,700,000
			Surplus	1,800,000
		$6,000,000		$6,000,000

Without additional outside financing, it is now decided to expand the fixed plant at a cost of $1,200,000. Assuming that the corporation has the necessary cash, the following change would be effected upon the completion of the new units:

ASSETS			LIABILITIES	
Current assets		$2,800,000	Current liabilities	$1,000,000
Fixed assets	$3,600,000		Bonds	500,000
Less: Depreciation reserve	400,000	3,200,000	Capital stock	2,790,000
			Surplus	1,800,000
		$6,000,000		$6,000,000

The expansion, as provided, affected only the asset position of the company; and the individual equities were in no way changed. However, it is next decided that the corporation's current financial position is not impaired by the extension and that the addition be officially and permanently recorded as coming from accumulated earnings. Hence, the gen-

eral surplus account will be decreased by the amount of the expansion and a new reserve for improvement account established. Giving effect to this, the balance sheet would now appear as follows:

ASSETS			LIABILITIES	
Current assets...........		$2,800,000	Current liabilities.......	$1,000,000
Fixed assets.............	$3,600,000		Bonds................	500,000
Less: Depreciation reserve...........	400,000	3,200,000	Capital stock..........	2,700,000
			Reserve for improvements............	1,200,000
			Surplus...............	600,000
		$6,000,000		$6,000,000

In the establishment of this reserve for improvements account, the expansion actually occurred first; but the procedure may be reversed. The principles are essentially the same, however, because (1) a reserve for improvements would be created by reducing the general surplus account by a like amount; and (2) upon the actual construction of the new plant, fixed assets would be increased and current assets decreased (assuming no new financing).

Although the creation of a reserve for improvements does not immediately provide the means of constructing the new additions, it does provide for the funds in an ultimate sense. By setting up a reserve for improvements, that amount is no longer available directly for dividend declarations; and hence, in an indirect way, the retention of an equal amount of assets is assured automatically. Of course, the funds or assets could be retained by means of a general policy; but the existence of a separate reserve account publicly announces the policy of permanent retention of assets on a legal as well as an economic basis. By the establishment of the account, the stockholders are informed to a certain extent of the expansion program and the source of the funds for its financing. It is desirable for concerns that are expanding through the medium of earnings to adopt some specific procedure rather than blindly accumulate the funds through the general surplus channel without mentioning the fact to the stockholder.

Reserve for Contingencies. Although a general surplus account is in itself a reserve for contingencies, conditions arise where it may prove desirable to set up a special reserve account. The following circumstances may make this desirable:

1. If definite contingencies are anticipated, it is sound financial policy to provide for them in advance of the actual events.

2. Transferring funds from the general surplus account prevents the use of such funds for dividend appropriations or other purposes.

3. A separate reserve for contingencies (either of the remote or near type) is of value as a matter of information to the stockholders and the creditors of the corporation.

In current practice, the reserve for contingencies is frequently combined with miscellaneous and other reserves in the actual balance sheet presentation. When the contingency occurs, the reserve will be reduced by the amount of the loss. For this reason, the question arises as to whether the reserve for contingencies is an earmarked form of surplus or a provision to discharge a liability. If the contingency is reasonably certain, the latter view should prevail; and the contingency reserve should be classed with the liability reserves. Otherwise, it may be considered a part of surplus. In either event, it is a part of surplus until the contingency actually takes place. Again, the reserve for contingencies is a simple accounting entry; but it does much to advance the financial program.

Sinking Fund Reserve. Upon first thought, one is apt to regard the sinking fund reserve as a liability. Is it not required by a bond indenture and, therefore, in the nature of a liability? The confusion again arises from thinking of reserves in terms of specific assets. To reveal its true setting, the following balance sheet tracing the flow of the account may be studied:

ASSETS		LIABILITIES	
Current assets	$2,000,000	Current liabilities	$ 800,000
Fixed assets	1,500,000	Bonds	1,000,000
		Capital stock	1,700,000
	$3,500,000		$3,500,000

Assuming that the bonds are to be retired at the end of the tenth year and that all excess earnings except the sinking fund reserve requirements are utilized for dividend purposes, the balance sheet would then appear (assuming perfect maintenance of the fixed assets) as follows:

ASSETS		LIABILITIES	
Current assets	$3,000,000	Current liabilities	$ 800,000
Fixed assets	1,500,000	Bonds	1,000,000
		Capital stock	1,700,000
		Sinking fund reserve	1,000,000
	$4,500,000		$4,500,000

With the payment of the bonds, the balance sheet would be as shown below:

ASSETS		LIABILITIES	
Current assets	$2,000,000	Current liabilities	$ 800,000
Fixed assets	1,500,000	Capital stock	1,700,000
		Sinking fund reserve	1,000,000
	$3,500,000		$3,500,000

Upon the retirement of the bonds, it is evident that the sinking fund reserve is no longer necessary and that the stockholders have provided funds out of earnings to supplant those originally obtained by the as-

sumption of debt. To give recognition to this change, the sinking fund reserve may be transferred to the general surplus account with the extinction of the bond issue.

If specific funds are desired to retire the bonds, a fund instead of a reserve (or else the two in conjunction) should be employed. Assuming a sinking fund and a sinking fund reserve as well as the perfect maintenance and replacement of the fixed assets, the balance sheet at the end of the tenth year would appear as follows:

ASSETS		LIABILITIES	
Current assets	$2,000,000	Current liabilities	$ 800,000
Sinking fund	1,000,000	Bonds	1,000,000
Fixed assets	1,500,000	Capital stock	1,700,000
		Sinking fund reserve	1,000,000
	$4,500,000		$4,500,000

When the bonds are retired, the fund would, of course, disappear; and the sinking fund reserve would be restored to the surplus account. The accounting entries would be to debit the bond account and credit the sinking fund account, thereby reflecting the payment of the bonds with the accumulated sinking fund. The next entry would be to debit the sinking fund reserve and credit surplus to return the appropriated surplus to the general surplus account.

Reserve for Insurance. The United States Steel Corporation presents in its balance sheet for December 31, 1960, an insurance reserve of $50,000,000. In some respects, such a reserve partakes of the nature of a contingency reserve in that it provides for possible future losses. The differences between the two are as follows:

1. Insurance reserves are provided for items that may be estimated on an actuarial basis or that fall into the category of normal or recurring business risks.

2. Insurance reserves cover possibilities that are more likely to occur. It is classified with the proprietary reserves because it represents an equity of shareholders until a loss is actually experienced. Unlike a liability reserve, it is not certain to be *paid out.*

In the interest of sound financial administration, very few enterprises should carry their own insurance. Only the large concern with diversified and scattered properties may do so successfully. Even here, it may be well to supplement the self-insurance with a policy from an insurance company to cover abnormal and extreme risks. In either case, adequate insurance is most essential to protect fully the long-time investor. For this reason, new enterprises should seldom attempt to insure themselves. This applies equally to a new, large concern, since self-insurance would intensify the risk too greatly at the inception of the enterprise.

Reserve for Dividends. In the preceding chapter, the merits of a stable dividend policy were discussed. This program may be assisted by estab-

lishing a reserve for dividends. It is not uncommon to find a reserve for preferred dividends, but this is generally the result of an indenture requirement. In addition, it may be equally good policy to provide for a reserve for dividends on common stock. Illustrative of such a practice is the case of the ACF Industries, Incorporated, formerly the American Car and Foundry Company, which carried a "reserve for common dividends" in the constant amount of $753,745 every year from 1944 to 1952. Again, the creation of the reserve would not set aside specific funds for the purpose; this could be accomplished only by setting up a concomitant dividend fund. Such practice is rare because (1) it is desired to have the funds available for general purposes, and (2) the funds can generally be employed more profitably when used for business operations than when treated on a fund basis.

Reserve for Working Capital. The purpose of a reserve for working capital is to retain assets in the business for the express purpose of strengthening the current position of the company. Its creation does not directly or necessarily increase any specific current asset as much as it may lead to the increase of the current items as a whole. The improvement in the working capital position may also be the direct outcome of a reduction of the current liabilities. In either event, the process is facilitated by the retention of assets assured by setting up a specific reserve for working capital.

RECENT TRENDS IN RESERVE ACCOUNTING

During the past decade, a marked change in proprietary reserve accounting practices has taken place. Reserves of the types discussed in the preceding pages are still to be found as matters of fairly common practice. However, it would be unusual to find all of them used by one company. On the contrary there appears to be a tendency to reduce the use of proprietary reserves wherever the opportunity exists, and the presentation of a single reserve caption is sufficiently descriptive, either with or without a footnote. Even the tendency to use a single reserve, an account termed "earned surplus—appropriated," is declining. An illustration of this practice is the case of the Borden Company, which carried the following proprietary reserves on its 1949 balance sheet:

Contingency reserve	$ 2,000,000
Inventory price decline reserve	5,000,000
Unusual property disposal reserve	5,000,000
Insurance and other operating reserves	11,251,000

In 1950, the company closed out the first three reserves and divided the earned surplus as follows:

Earned surplus—appropriated	$12,000,000
Earned surplus—unappropriated	77,326,831

In 1960, the company carried only one reserve account, "Reserves (Insurance, etc.) $6,968,920" and one earned surplus account, "Earned surplus (earnings retained for use in the business) $145,642,326."

At least part of the trend toward simplification may be attributed to the effort of the Securities and Exchange Commission. This agency has been the advocate of simple and clear financial practices and has opposed any methods tending to create confusion or misunderstanding on the part of the investor. Correct labeling of reserves and limiting their creation to clear-cut financial purposes have this effect.

The only new reserve to make a frequent appearance in the last decade is the reserve for increased replacement costs. This reserve is intended to recognize situations wherein depreciation reserves (usually based on original cost) are inadequate for replacement of the physical assets. With a price level averaging approximately double the prewar level, many companies have argued that depreciation based on cost will recover the original investment but not replace the asset. Accordingly, they have made provision out of earned surplus to give recognition to this situation.

This policy for handling increased replacement costs is in accordance with accepted and conservative accounting principles.[4] Accountants usually contend that depreciation is a means of recovering the investment in an asset subject to wear and tear in use or with the passage of time. It is not intended to provide for a new asset when, as, and if a new one is purchased. Moreover, few companies would be willing to use replacement costs under conditions of falling price levels—at least not for income-tax purposes. On the other hand, it may be argued that earnings are overstated and that the computed earnings are not, in fact, available for distribution. Instead, the earnings must be used to finance higher replacement costs of fixed assets. To the extent that this is true, the amount can be calculated and shown by the appropriation of surplus to a special reserve account. Or an appropriated surplus account can be set up and its intended use explained in a footnote to the balance sheet.

LIABILITY RESERVE ACCOUNTS

Liability reserves are usually provided to care for liabilities arising out of current operations; the only question to be determined is the amount. The most common examples of this class of reserve are the reserve for taxes and the reserve for pensions.

Tax liabilities have become an extremely important factor in the operations of corporations. Ordinarily, the amount of tax obligations, particularly of income taxes, cannot be determined until after the close of the taxable year. As a consequence, some corporations establish reserve accounts to provide for this expense. However, accountants are inclined to

[4] American Institute of Accountants, *Depreciation and High Cost* (Accounting Research Bulletin No. 33 [December, 1947]).

look with disfavor on the use of reserves to provide for current tax obligations. They prefer the use of an accrued taxes account which is listed with the current liabilities. Under this procedure, reserves for taxes are limited to past-due taxes or tax deficiencies.

It is becoming a general practice for corporations to establish pension or employee welfare systems for their employees. At the time the systems are established, a substantial accumulated obligation may be assumed, the exact amount of which cannot be calculated and should not be chargeable to any given year. This may be recognized by providing a reserve out of current earnings. As an illustration, in its 1960 *Annual Report,* the Allied Chemical Corporation carried a "reserve for pensions, $50,156,777." General Motors Corporation carried an account "reserve for employees benefit plans $26,658,346."

In contrast, there is the type of liability reserve which arises from some specific and nonrecurring event. An example would be a reserve for damages arising out of a lawsuit. Such a reserve could be established through an appropriation of surplus or as a transfer from the contingency reserve. The lawsuit is a contingency that has occurred, although the claims have not yet been paid.

TRUSTEE ASPECTS OF RETENTION OF EARNINGS

The retention of earnings in a business illustrates in a peculiar way some of the qualities of trusteeship which are now being associated with corporate management. This is true from the viewpoint of both investors and the larger public interest. As to the former, present dividends of immediate certainty are sacrificed for possible later returns with all the risk of future prospects. There is no element of choice on the part of investors as was true of their initial investment, but the management presumes to act for the investors' benefit. This delegation of authority is inescapable in our present business system, but it is important that management be conscious of its part in acting for the welfare of others. Too often, there is a tacit assumption that the earnings belong especially to the corporation and are not comparable to the capital investment which is represented by formal certificates. Business integrity demands, however, an equal accounting for funds, irrespective of their source, with due recognition of the shareholders' interests.

Some attention has also been given in recent years to the possible effects of the reinvestment of earnings upon society as a whole. Not only is the question raised because of the lag in current purchasing power, but doubts have been expressed about the distribution of new capital. It is contended that the automatic inbreeding of capital is without the full benefit of market influence and that the removal of these funds from the market deprives other industries of an opportunity to compete for the funds. The merits of this larger economic issue will not be debated here;

but in self-defense, management would do well to give an adequate accounting for this internal use of funds.

QUESTIONS AND PROBLEMS

1. One writer refers to retained earnings as "inequity capital" (See *Fortune*, April, 1950, p. 79). What is meant by this statement? Discuss its merits.
2. Why is it more difficult for utility companies to accumulate a large surplus than industrial companies?
3. On page 499, the following statement is made: "Irrespective of safety and profits, the momentum of a going concern requires the infusion of new funds to meet the fluctuations of businesss as well as for purposes of normal expansion." Explain and discuss.
4. Compare the surplus position of a representative railroad with that of (*a*) a representative industrial company and (*b*) a representative electric utility.
5. Compare the surplus position of any two comparable industrial companies, and comment on the results.
6. "It is not the amount of surplus but rather what is done with it that determines the soundness of financial position." Discuss.
7. "Surplus which is to be retained in the business permanently should be converted into capital stock by the use of stock dividends." Discuss.
8. Discuss the arguments for and against the use of replacement value as a basis for charging depreciation.
9. Show how companies with foreign holdings may have particular need for a reserve for contingencies.
10. Discuss the relative advantages of a sinking fund and a sinking fund reserve as a means of protection to bondholders.
11. What are the arguments for and against self-insurance? Discuss the nature of a reserve for insurance. Would you favor the segregation of funds (assets) in equal amount?
12. Explain the variations between 1952 and 1957 in Table 50?

REFERENCES

Burtchett, Floyd F., and Hicks, Clifford M. *Corporation Finance*, chap. xxxi. 3d ed. Lincoln, Nebraska: Johnsen Publishing Co., 1959.

Dewing, A. S. *Financial Policy of Corporations*, chaps. xxv–xxvi. New York: The Ronald Press Co., 1953.

Gerstenberg, Charles W. *Financial Organization and Management*, chap. viii. 4th rev. ed. Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1959.

Osborn, Richards C. *Corporation Finance*, chap. xx. New York: Harper & Brothers, 1959.

Chapter 26 ►

NATURE AND COMPOSITION OF WORKING CAPITAL

THE TRANSMUTATION of a company's working capital into income and profits, and back into working capital is one of the most dynamic and vital aspects of business operation. In oversimplified terms, this operation concerns management's expenditure of funds in the anticipation that it will receive not only a return of those funds, but a profit as well. The financial aspects of these operations are basic, regardless of the nature of the productive activities of the company—be it mine, mill, factory, foundry, shop, or store. Funds are paid out for goods or services in the expectation that through the sale of such goods or services, when placed in salable condition, the outlay for their cost and all collateral expenses will be recouped, together with an appropriate profit.

A truly full consideration of this process would take us into the fascinating dynamics of business management as a whole. However, our attention will be confined to the significant phase of the all pervasive effects of the working capital metamorphosis. In this connection, it must be remembered that business activity is always dynamic and often subject to wide fluctuations. Furthermore, a proper relationship must be maintained between the current capital and fixed capital of an enterprise, if operations are to run smoothly. And finally, sufficient liquidity must be achieved to provide for maturing obligations. These axioms apply whether a company is making a profit or losing money.

The complementary relationship between current and fixed assets is readily apparent. A fully equipped factory without a supply of materials to process or without cash to pay workmen's wages and other current expense, or a store without merchandise to sell, is virtually useless. Consequently, the working capital position of any enterprise—particularly its cash position—may readily become the controlling factor determining the scope and character of its operation. At the end of 1960 for instance, it was estimated that all manufacturing corporations in the United States had total assets of $256 billion; net plant, property, and equipment of

$100.5 billion; and total current assets of $133.8 billion including cash and U.S. government securities of $27.6 billion. Percentagewise, net plant, property and equipment constituted 39.3 per cent of total assets, while current assets were 52.3 per cent of total assets. Cash and U.S. government securities equaled 20.7 per cent of current assets, and 10.8 per cent of total assets.[1]

The ratio of current to total assets varies from industry to industry, and from company to company, as well as at different periods of the economic cycle, as will be shown. For example, companies in the petroleum refining industry had around 58 per cent of their total assets invested in net property, plant, and equipment, at the end of 1960. As of the same date, the tobacco manufacturers required only around 11 per cent of their total investment to be placed in net fixed assets. The contrasting nature of these two industries is further reflected in the fact that the petroleum refining companies use around 30 per cent of their total assets for their working capital. The tobacco manufacturers on the other hand are required to concentrate the major part of their total investment in current assets, which average about 87 per cent of total assets.[2]

While all aspects of the operation of an enterprise are interrelated, the management of the working capital is of such moment that it frequently assumes specialized characteristics. Particularly is this true in large organizations, with their executive, finance, and budget committees; close control of purchasing, production, and stocking of inventories; and credit and collection policies. In new and smaller corporations, the adequacy of cash and other current assets, as well as their efficient handling to meet necessary obligations, virtually determines the life or death of the enterprise. It is for these reasons that separate consideration is given to the nature, function, source, and importance of working capital in the financial destiny of an enterprise.

CAPITAL DEFINED

It is important to have in mind an understanding of the concept of capital in its broader sense prior to any discussion of working capital. As with most economic concepts, the term may be defined in many ways. The economist defines "capital" as wealth used in further production and stresses physical facilities without regard to their money values. Contrariwise, the businessman uses the word "capital" with special reference to the money or money values used in the business, regardless of source. For some purposes, capital is thought of as the face or book values de-

---

[1] Derived from Federal Trade Commission and Securities and Exchange Commission, *Quarterly Financial Report for Manufacturing Companies: Fourth Quarter, 1960* (Washington, D.C.: U.S. Government Printing Office, 1960).

[2] *Ibid.*

picting the stock and bond liabilities of the business; for other purposes, it is regarded as the asset values of the enterprise.

CLASSES OF CAPITAL

Capital, in terms of assets, as well as in use, may be classified as relatively fixed (or permanently installed) capital and working (or circulating) capital. The fixed capital is represented by buildings, land, machinery, and similar assets of a relatively permanent nature. These assets have a long life; and once funds are invested in them, adjustments become difficult. They represent the productive component of the business; they are utilized with or act upon the current or circulating capital to produce revenue; they themselves are not expected to be sold to produce revenue or income for the enterprise. The expenditures for this class of assets are expected to be recovered only over a period of years through depreciation charges, which are an element of cost. These costs, together with other expenses incidental to placing an item in salable condition, plus an appropriate markup for gross profit, constitute the sales price of inventory items. Transportation and other service industries, such as public-utility companies, recoup their expenditures for plant and other fixed assets through provision for depreciation costs in their charges for service, be it railroad, bus, or car fares; freight bills; or charges for gas, electricity, or telephone service. In addition to depreciation expenses, companies operating in the extractive industries, such as the oil and natural gas industries, make a further charge against operating costs to cover the depletion of certain types of their capital. This capital is actually physically withdrawn from their store of assets—oil or gas in the ground—and sold as an end product. Management usually regards both the depreciation and depletion accruals as a contributing source to their working capital.

Working capital consists broadly of that portion of the assets of the business used in, or related to, current operations, and represented at any one time of the operating cycle by such items as accounts receivable, inventories of raw materials, supplies, work in process and finished goods, or merchandise, notes or bills receivable, and cash. Assets of this type are relatively temporary in nature, since the invested values are normally capable of being recovered or of being changed in form within a short period of time. Of course the time element of ultimate recovery depends on the manufacturing cycle, as well as the sales and collection cycles. The dual nature of many manufactured products should also be noted. The inventory of the seller often becomes the productive capital of the buyer.

An automobile or truck coming off the assembly line of Chrysler Corporation, for instance, is part of its current assets or working capital. In the hands of a Detroit department store it becomes part of the latter's

productive capital. Machine tools such as lathes, shapers, and planers are normally thought of as producers' goods, but in the hands of the machine tool manufacturer who produced them they are part of his inventory, and hence working capital.

The dual operating and financial function related to working capital has its ever present risks. Loss may arise not only from a shrinkage in values occasioned by unbalanced costs, but also from the purchase or production of a slow selling or nonselling end product or the uncollectibility of accounts receivable resulting from sales. A general decline in the local or national economy can cause losses, as can a rapid rise in prices after commitments made on expectations of a lower range of costs. Mismanagement can easily lead to the conversion of necessary current assets into fixed capital, which tends to destroy the liquidity that is so essential to a sound business position.

It is because of these ever present hazards that managers have to be extraordinarily watchful to convert the proper amount of cash that flows into their hands from all sources of the business back into the working assets. It is these assets, which after their transmutation into salable end-products, actually produce the revenues of a business. The purpose, of course, is to sell the products at a price equal to all costs plus a profit. The revenues, for the most part, are initially in the form of accounts receivable, since most sales are on a credit basis. The proceeds of these receivables provide the wellsprings for a new cycle of circulating capital, and the realizable profits of a business. These profits of course can be used to increase the working capital funds, to make permanent expansions, or to pay dividends.

WORKING CAPITAL DEFINED

Like the broader concept of capital, there is no universally accepted definition of working capital. Some authorities define the term "working capital" as the difference between current assets and current liabilities.[3] Other writers think of working capital as being equal to the total of the current assets.[4] The first approach is qualitative in character because it provides a measurement of the reliability and possible availability of current assets. To illustrate, the following current positions of companies A and B may be noted:

[3] This is the definition used by most financial services and by many writers emphasizing the accounting phase of finance. See Harry A. Finney and Richard S Oldberg, *Lawyer's Guide to Accounting* (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1955), p. 186; Charles W. Gerstenberg, *Financial Organization and Management* (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1959), p. 282; Harry G. Guthmann, *Analysis of Financial Statements* (New York: Prentice-Hall, Inc., 1952), p. 63.

[4] Ralph D. Kennedy and Stewart Yarwood McMullen, *Financial Statements, Form, Analysis and Interpretation* (Homewood, Illinois: Richard D. Irwin, Inc., 1957), p. 209; Lillian Doris, ed., *Business Finance Handbook* (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1953), p. 4.

Working Capital Items	Company A	Company B
Current assets	$10,000,000	$10,000,000
Current liabilities	4,000,000	8,000,000
Net working capital	$ 6,000,000	$ 2,000,000

Analysis of this comparative statement obviously indicates that A has a stronger position than B. Both companies have the same amount of gross working assets, but it is clear that A is on a more substantial basis. There is less danger of A's losing its gross position by the pressing demand of current liabilities which must be discharged through payment in cash or some form of refinancing. Investors whose primary interest is in financial soundness will, therefore, be wise in using the net figure as the best measure of the working capital position. Credit managers also use the net concept since it affords a measure of the unencumbered current assets and, hence, of the margin of protection available for the current creditors.

From management's point of view, the chief difficulty with the net concept of working capital arises from the fact that it is impossible to increase working capital through current borrowings. For illustrative purposes, we may assume that a company borrows $1,000,000 from its commercial bank. As a result, the cash account is increased by that amount; and the notes payable account is increased by a like amount. According to the net concept of working capital, there has been no change. Yet, from the point of view of funds available for operating purposes, there can be little doubt that there has been an increase of $1,000,000. As a consequence, management prefers the gross working capital or total current assets concept.

The total current assets concept has a broad application. As we have observed, it takes into consideration all the current resources of the enterprise, from whatever source derived, and their application to the current and future activities of the enterprise. In the balance sheet the cash account usually shows as a single item. Cash together with unallocated marketable securities constitute a company's liquid resources. Frequently these are substantially larger than the amount necessary to finance the regular cycle of current operations. The balance is held for other uses of the business, as well as a necessary reserve for unexpected happenings and emergencies. Efficient management, through foresighted budgeting, marshals its resources, in point of time, to meet its obligations. These include provision for capital expenditures as well as current operations.

The flow of major items through the cash account of a business and their effect on its working capital, or financial position, is illustrated by excerpts from three annual reports covering 1960 operations in different

industries. These statements also give point to our previous observation of the various concepts of what constitutes working capital and the manner of its use. In the accompanying United States Steel statement[5] for instance, although the term net working capital is not used, the amounts signify that the final figure reported represents the difference between the current assets and current liabilities. In other words, the company chose to emphasize its unencumbered financial position rather than its current working assets.

SUMMARY OF 1960 FINANCIAL OPERATIONS

Additions to working capital		
Income		$304,170,990
Add—Wear and exhaustion of facilities		208,424,291
Proceeds from sales and salvage of plant and equipment		8,265,089
Proceeds from sale of common stock under Stock Option Incentive Plan		2,932,500
Miscellaneous additions		528,756
Total additions		$524,321,626
Deductions from working capital		
Expended for plant and equipment	$492,401,892	
Less—Use of funds set aside in prior years	195,000,000	
	$297,401,892	
Added to costs applicable to future periods	14,322,103	
Reduction in total long-term debt	32,805,544	
Dividends declared on preferred and common stocks	187,235,868	
Total deductions		531,765,407
Reduction in working capital		$ 7,443,781
Working capital per consolidated statement of financial position		
December 31, 1960	$608,094,605	
December 31, 1959	615,538,386	
Reduction in working capital		$ 7,443,781

The item among the additions to working capital "add—wear and exhaustion of facilities—$208,424,291" is of especial interest. It is derived from charges to income as shown in the following summarized 1960 income account of the company. The income account has been rearranged to highlight our particular point of interest.

CONSOLIDATED STATEMENT OF INCOME, 1960

Products and services sold	$3,698,494,931
Costs	
Wear and exhaustion of facilities	208,424,291
All other	3,185,899,650
Total	$3,394,323,941
Net income	$ 304,170,990
Dividends declared on preferred and common stocks	187,235,868
Income reinvested in business	$ 116,935,122

[5] United States Steel Corporation, *Annual Report,* 1960, pp. 30–32.

This "wear and exhaustion of facilities" in and of itself does not produce anything of tangible value. Quite the contrary. As a matter of fact it represents a future cost to the business when it becomes necessary to replace the worn-out or obsolete facilities. However, this wearing-out action does result in a financial value by a process of metamorphosis with which business abounds. As we have observed, the recoupment to the enterprise of the results of depreciation—the gradual wear and exhaustion of physical facilities—is provided for by management on a periodic basis. It is accomplished by including an appropriate amount along with the rest of its expenses to be included in the total cost of each period of operation. These costs, together with an additional amount to cover profit, are recouped through the sales price of the company's product. This process in its aggregate form is illustrated in the income account summarized above.

The accounting for depreciation expense as we have observed, does not require an immediate cash expenditure. The reason for this is that replacements for wear and tear are made only periodically. However, the amount of depreciation included in the expenses is recovered in cash in the gross revenues received from the current sale of the company's products. This part of the total cash recovery is of course, included in the company's cash account. It is thus available for any corporate purpose. It is for the foregoing reasons that depreciation, which is shown in the income statement as an expense, is variously described in the working capital analysis as "non-cash charges against income," "charges to profit not requiring funds," "depreciation and amortization expenses charged against operations but not requiring cash," etc.

The Ford Motor Company working capital analysis offers an informative and interesting presentation of the major factor affecting this component. Equally of interest is the manner in which these changes are reflected in the various elements of the working capital position, as shown below:[6]

Net Working Capital

The items contributing to the changes in the Company's net working capital during 1960 and 1959 are summarized in the following table:

	1960 (in millions)	*1959 (in millions)*
Increases		
Net income for the year	$427.9	$451.4
Less, Dividends paid	164.6	153.5
Retained earnings	$263.3	$297.9
Non-cash charges against income, principally depreciation and amortization	303.5	385.6
Issuance of additional shares of capital stock	1.6	4.0
Total increases	$568.4	$687.5

[6] Ford Motor Company, *Annual Report, 1960*, pp. 24–25.

	1960 (in millions)	1959 (in millions)
Decreases		
Additions to property, plant and equipment (including special tools) less proceeds from sales of property	$287.1	$224.1
Purchase of additional shares of Ford Motor Co. of Canada, Ltd.	.3	148.5
Appropriation of cash for purchase of ordinary stock units of Ford Motor Co., Ltd. (England)	370.9	—
Increase in equity in net assets of unconsolidated subsidiaries and foreign branches	91.2	59.3
Increase in investments and non-current receivables	.4	(3.6)
Transfer to current liabilities and purchase of 4 per cent promissory notes	10.0	.5
Total decreases	$759.9	$428.8
INCREASE (DECREASE) IN NET WORKING CAPITAL	($191.5)	$258.7

Net working capital decreased $191.5 million during 1960 principally because gross additions to property, plant and equipment, and appropriations of cash to purchase additional stock in Ford Motor Co., Ltd. of England exceeded retained earnings and non-cash charges against income. As shown in the following table, most of the decrease in net working capital was reflected in decreased cash and marketable securities.

	1960 (in millions)	1959 (in millions)	Increase (Decrease) in Net Working Capital (in millions)
Current assets:			
Cash and marketable securities	$ 454.1	$ 666.3	($212.2)
Receivables	193.0	147.4	45.6
Inventories	527.8	520.4	7.4
Prepaid expenses	23.4	23.6	(0.2)
Total current assets	$1,198.3	$1,357.7	($159.4)
Total current liabilities	560.6	528.5	32.1
Net working capital	$ 637.7	$ 829.2	($191.5)
Ratio of current assets to current liabilities	2.1 to 1	2.6 to 1	

MANAGEMENT AND TYPES OF WORKING CAPITAL

The prime object of management is to make a profit. Whether or not this is accomplished in most businesses depends largely on the manner in which the working capital is administered. The amount of working capital, its distribution among the various current asset classifications, and the method of its financing must be determined in conjunction with other aspects of business operation, among which are sales and credit policies. The business must operate as a whole. However, there are special problems peculiar to the management of working capital requiring operating and financial skills of an increasingly higher order as the degree of business complexity increases. The specific application of some of these skills in the detailed management of working capital is a subject in itself. At

this point we are concerned more with the major types of current assets, than their administration.

Cash. In many respects, cash is the most important item in business operation. It is both a means and an end of business enterprise. Return upon the investment takes form usually through the payment of cash dividends; and in the event of liquidation, cash becomes the final medium by which claims are discharged. Likewise, cash is one of the most important tools of day-to-day operation because it is a form of liquid capital which is available for assignment to any new use. Cash is often the primary factor deciding the course of business destiny. The decision to expand the business may be determined by the availability of cash, and the borrowing of funds will frequently be dictated by the cash position. There is never a time in the life cycle of a business that cash, or the ready access to it, is not important. However, it is of paramount importance for a new corporation to have an adequate supply of cash during its provisional stages and early years of operation. No matter how carefully the cycle of operations is estimated, and the meeting of obligations calculated, these plans seem almost invariably to go awry. This is particularly so with small companies.

Raw materials for manufacture, or merchandise for sale, may not be forthcoming on time; operations in the plant may be slow or inefficient; some goods may be returned; some customers may not pay on time, if ever. Costs may rise, but prices remain fixed. At all events the smooth cycle of expenditures and receipts that was visualized does not occur. Unless there is an adequate supply of cash to bridge the gap a stringency develops. Operations are slowed, if not paralyzed. Creditors press the collection of their claims. If payment cannot be made, or adjustments effected, bankruptcy and failure follow.

Even after companies have surmounted their initial financial growing pains, the daily cash position continues as a key factor in their operations. Many large companies maintain large liquid cash balances in excess of their immediate needs and borrow little, if at all, on current account. But some companies are not in this position and must frequently borrow their seasonal working capital requirements. Other companies deliberately plan their financing and operations to provide their seasonal requirements from bank borrowings. In such cases, plans must be carefully made so as to provide adequate cash to repay the current loans when due. Credit is maintained only by meeting promptly all obligations of the company as they mature.

No easy formula can determine the amount of cash a company should maintain. It depends on many factors. Some of these are the manufacturing cycle, the sales and collection cycles, the extent that warehousing of inventory might be required, and the matter of maturing debt. Important also is management policy toward the carrying of cash in excess of immediate current needs, granted that it has the resources. The matter

of expansion is frequently a factor. The general economic outlook and the financial and banking situation are always important considerations. Then, too, the all-pervasive matter of prices—their level and possible direction—influences the judgment of management as to the amount of cash that should be maintained.

The price level of all commodities for instance rose about 75 per cent between the end of World War II, and December, 1960. But all prices did not move alike or maintain the same direction. Raw materials, particularly farm products advanced rapidly until their peak in 1951 and then declined steadily until the end of 1960. Fabricated goods as a group, on the other hand, lagged behind raw materials, but then moved steadily higher while farm prices were declining. Metals, particularly copper, moved erratically during this period, responding to world conditions and markets. The volume of business transacted, both in physical quantities and in dollars, expanded enormously. Gross national product, for instance, rose from $210.7 billion in 1946 to an annual rate of $503.2 billion in the fourth quarter of 1960, as measured in current dollars. This is an increase of 139 per cent.

As an illustration of what these price and growth changes have meant to businessmen and their cash requirements, let us assume a businessman's costs have increased roughly 100 per cent since 1946. Then to transact the same volume of business now as in 1946, he requires $2.00, where formerly $1.00 was sufficient. If his physical volume of business has increased from 1,000,000 to 1,500,000 units, or 50 per cent, he will now require $3,000,000 to handle it, whereas at 1946 price levels he could have transacted the expanded business with $1,500,000.

Companies that have large tax payments to meet frequently invest a portion of their cash in readily marketable securities. These latter are usually United States government short-term notes and bills; commercial paper may also be used. Companies doing an important business in Canada often invest part of their funds in Canadian government securities. In any consideration of a company's "cash position," its unallocated holdings of marketable securities are added to its actual cash-on-hand and bank deposits for comparison purposes. This is a logical procedure, since most managements seek to avoid having too much redundant cash by investing a portion of it in earning assets that can quickly be converted into cash as required.

In Table 52 the "cash position" of selected industrial corporations expressed as a percentage of their total assets is presented for various years between 1929 and 1960. The early years, 1929 and 1933, were selected to show the last year of a boom period and a year of extreme depression. The years following the depression and into the war years are not depicted. However, for most of the companies shown, this was a period of steady gain in cash resources. The year 1946 was selected as the first complete postwar year. Succeeding years were selected to show various

broad movements in the economy as a whole and to conclude with the last two years available at this writing.

The increase in the importance of cash and securities observable in 1946 is principally a reflection of two factors. One is the greatly enlarged business volume experienced in that year in comparison with the depression year; and the other is the promptness with which changes in price levels are reflected in current asset items relative to the fixed assets. Conservative accounting practice carries fixed assets at cost. Such values once established change relatively slowly as depreciation is recognized and as assets are retired and replaced with similar items at differing costs.

The current asset, cash, has no valuation problem and is carried at face value. Marketable securities, usually government bonds and occasionally commercial paper, are carried at cost but normally represent a

TABLE 52

CASH AND MARKETABLE SECURITIES AS A PERCENTAGE OF TOTAL ASSETS*

Company	1929	1933	1946	1951	1954	1959	1960
Consolidated Cigar	5.2	9.4	9.1	4.9	6.9	5.5	5.2
Curtiss-Wright	11.5	5.2	81.5	6.5	14.7	25.1	29.8
Chrysler	18.4	25.3	35.8	25.7	15.7	14.1	23.8
Gulf Oil	3.8	4.7	6.4	18.8	19.4	12.9	13.0
Johns-Manville	5.5	10.2	7.0	8.0	7.2	17.9	15.9
Mead-Johnson	42.1	36.6	14.2	31.1	23.1	15.5	24.1
National Dairy	11.4	12.5	10.9	10.4	18.4	9.3	6.5
Pullman	22.2	13.9	42.1	13.2	27.5	9.9	16.1

* Based on data in *Moody's Industrials.*

temporary use for excess cash, as we have observed. Consequently, cash and marketable securities must follow, in general, the volume of business transacted by the corporation. During 1946, business volume increased for most corporations both in terms of physical volume and dollar volume, but it was a marked reduction in aircraft production which caused Curtiss-Wright assets to shift into cash.

This relative increase was due in part to business needs and in part to the fact that the book value of the fixed assets had not increased because of the normal lag. This situation generally found greater reflection in companies closer to the consumer markets than otherwise, as may be observed. The one exception is Consolidated Cigar. This company operates almost like a utility, having a steady cash inflow, permitting it to maintain a relatively small cash position. A large part of its investment is in inventory. Thus, although the company increased its cash resources around 25 per cent from 1954 to 1960, total assets including cash were increased by 60 per cent.

The data beginning with 1951 reflect both the substantial price inflation that has occurred in the economy since 1946 as well as the tremendous expansion in total assets and volume of business transacted for most

companies. The data also reflect the determination of many managements to maintain substantial amounts of cash. Johns-Manville, for instance, in the 1951–60 period nearly doubled its total assets while quadrupling its cash and security accounts with the result that the latter accounts were nearly twice their relative importance. In another sector of the industrial world, Chrysler offers a spectacular illustration of the power to attract cash, and its vital necessity to the survival of an enterprise.

In 1954, Chrysler had a bad sales year as the public became exceptionally style-conscious. Although Chrysler had excellently engineered products, they did not meet with popular favor. Sales fell, and Chrysler's position among the "big three" automobile companies was seriously jeopardized, as the remaining giants, Ford and General Motors, fought for supremacy. Chrysler responded with a sweeping improvement program. To supplement its already substantial resources, it arranged for a long-term loan from the Prudential Insurance Company of America for $250,000,000. This was to be received in installments of $62,500,000 on each July 1, during the years 1954 through 1957. In 1954, Chrysler spent $155,000,000 on land, buildings, and special tooling. In 1955, the figure was $204,000,000. These investments and the product changes which accompanied them made 1955 a successful year. Unit sales nearly doubled, while its share of the market increased from 13.2 per cent to 17.1 per cent. Earnings per share increased from $2.13 in 1954 to $11.49 in 1955.

Evidence that capital outlays are not always a solution to industry problems is furnished by the following four years. In 1956–59, Chrysler made new capital outlays of $281, $146, $150, and $241 million respectively. Yet sales in 1956 fell about 25 per cent from 1955 and per share earnings fell to $2.29. New models in 1957 were successful and share earnings rose to $13.75, only to be followed by deficits in 1958 and 1959. Quite clearly problems other than money resources existed.

Accounts Receivable. Another important item in the working capital classification is accounts receivable. At first glance, it would seem that these accounts might be more accurately described as a form of potential cash rather than real capital. As soon as they are collected, cash is provided that can be used in the business; but, prior to their realization, they represent the advance of capital to vendee firms receiving the benefit of the credit. Since, on occasion, an indefinite amount might be tied up in slow accounts or be lost outright in bad debts, the capital invested in receivables can never be regarded as certain to be converted 100 per cent into cash, particularly within the time limit planned by the working capital managers. But, from experience, a company can usually calculate to within a relatively small percentage the amount of receivables that will convert to cash, always barring an economic upset. At all events, accounts receivable arise from the need to finance sales in our highly integrated credit economy and are earning assets as much as machinery or inventories of goods on hand.

Accounts receivable may be used to clarify the confusion of terminology which applies to working capital. In the asset sense, accounts receivable are classified as a form of working capital, since they represent an earning asset necessary to the average business. However, accounts receivable lack availability to the business except as they mature and are returned in the form of cash or except as they may be used as security for short-term bank loans. It is equally clear that the accounts receivable must be accommodated or financed during the time they are outstanding. The means of this financing is found on the capital or liability side of the balance sheet and may arise from accounts payable, notes payable, or a portion of the permanent financing. Viewed in this complementary manner, it is clear that the two concepts of working capital which were previously set forth are for practical purposes two phases of the same problem. Net working capital reflects the source of funds; gross working capital indicates the use. This is true because if there were no current liabilities, net working capital would be equal to gross working capital; and the absence of current liabilities would indicate that the source must have been exclusively from permanent financing.

The amount that a given corporation may be expected to invest in receivables is a function of the volume of credit sales, the credit terms extended by the corporation, and the collection policy. In most industries, the credit terms are largely, if not entirely, set by trade practices. These change with economic and social conditions and practices.

Many corporations have steadily increased the amount they have invested in receivables since World War II. This applies both to percentage of net sales as well as percentage of working capital. The demand for credit has occurred at all levels of the production and distribution process. In 1948, department stores made 52 per cent of their sales on a cash basis, 41 per cent were "charge" sales, and 7 per cent were on installment. By 1960, cash sales had fallen to 43 per cent and nearly all of this had been picked up by installment plans of various kinds which then accounted for 15 per cent of sales.

Composite data for manufacturing companies suggest a similar trend in the use of credit selling. While not a measure of the amount of credit sales during the year, receivables on the books at the end of the year do show the extent to which sales must be financed. In 1948, receivables amounted to 21 per cent of the current assets of manufacturers; in 1955, the figure was nearly 24 per cent; and in 1960, the proportion had grown to 30 per cent.[7] The same expansion of credit was reflected by data for all United States corporations, excluding banks and insurance companies.[8]

[7] Federal Trade Commission and Securities Exchange Commission, *Quarterly Financial Report for Manufacturing Companies, Fourth Quarter*, 1948, 1955, 1960 (Washington, D.C.: U.S. Government Printing Office, 1949, 1956, 1961).

[8] Securities and Exchange Commission, *Working Capital of U.S. Corporations, Statistical Series Release No. 1744* (Washington, D.C.: U.S. Government Printing Office, 1961).

In 1948, notes and accounts receivable, including receivables from the United States government, approximated 31.2 per cent of total current assets; in 1955, this figure was 38 per cent. By 1960, it had grown to 45.1 per cent. Reflecting the influence of heavy extension of credit by various sources, commercial receivables approximated $76 billion at the end of 1955, compared with a total inventory investment of $69.8 billion. This state of affairs has appeared only rarely in the past; then it was only during years of war or semiwar conditions. Whether or not it represents a relatively permanent readjustment of heretofore existing relationships between receivables and inventory is difficult to determine. However, in 1960, the best available estimates were receivables $129.6 billion and inventories $91.3 billion.[9]

It would certainly appear that a large part of the American public is determined to enjoy the good things of life on a "pay-as-you-use-it" basis. This is in sharp contrast to the savings or "pay-as-you-go" basis that dominated the early life of the country. Studies indicate that a large section of the consuming public do not save very much and are avid purchasers on credit. The vast expansion of credit all through the decade of the 1950's would indicate that a great many corporations and financial institutions have arranged their operations and financing to accommodate this relatively new economic phenomenon.

Inventories. In point of dollar value, inventories constitute the principal item in the working capital of the majority of trading and industrial companies. Composite data for all manufacturing corporations in the United States for instance indicate that inventories constituted between 24 per cent and 27.5 per cent of total assets in the years 1947 through 1950; the pattern was substantially the same during the period 1951 through 1960. However, the lower percentages were established in the latter part of the middle fifties. This reflects in part the rise in the dollar amount of receivables held, as we have observed, as well as the substantial increase in net plant investment. In so far as working capital is concerned, inventories constitute a substantial part of these current assets. In the 1947–50 period their range was between 42 and 48 per cent of working capital; in the 1951–55 period inventories averaged between 43 per cent and 46 per cent.

Inventories of manufacturers comprise stocks of raw materials and supplies, goods in process, parts, and finished goods. Wholesalers in different lines of trade will carry stocks for sale to manufacturers or retailers. Retail companies, for the most part, will have stocks of finished goods which are available for sale to the final consumer. Physical and financial control of these inventories in all lines of activity in which they comprise a substantial part of the current assets is frequently the most important problem in the administration of the working capital fund.

[9] *Ibid.*

Management of inventory is designed to regulate the size of the investment in goods on hand, the types of goods carried in stock, and turnover rates. Adequate stocks of goods of proper quality to meet the needs of production and sales must be maintained, while at the same time the investment is kept to a minimum. In normal times, when delivery schedules can be calculated almost to the hour, mass-production industries, with their huge investments in inventories, sometimes carry as little as a twenty-four-hour supply of raw materials for their processing needs during the good-weather season. Co-ordination between purchasing, traffic, and production departments achieves this inventory control phenomenon; but it requires a smoothly running economy to function uninterruptedly in high gear. When such a system does function efficiently, it reduces, by a substantial amount, investment in idle, but otherwise necessary, stocks of inventories for processing.

The factors determining the amount of the investment in the inventory, aside from purchasing policies, which alone can vitally affect the destinies of the enterprise, arise from such elements as the seasonal variations characteristic of the line, the time lag which exists between purchase and sale, and the amount required for a smooth flow of operations. A firm having a reasonably stable volume of business throughout the year will have a simpler inventory problem than a firm with a highly seasonal fluctuation. The latter company has a constantly varying inventory to finance and will likely need to carry out more financing transactions. Merchandising firms having a rapid turnover or manufacturers with a short processing cycle will tie up less capital in inventories than will firms with low turnovers or longer processing cycles. Certainty and regularity of supply are important in determining requirements from the viewpoint of operating continuity. If the source is outside the country or subject to the vagaries of weather, a greater inventory will be needed at times than would otherwise be true. The great steel companies must have sufficient ore on hand to carry their operations through the winter when Great Lakes shipping is icebound. For the same reason, the northern areas must have larger stocks of coal than territories close to the mines, which have access to rail transportation.

Where the inventory account occupies a prominent position in business operation, it will usually play a key role in deciding the success of the venture. Unwise stocking of raw materials can play havoc with the profit and loss account, and insufficient accumulation can seriously interfere with the normal flow of goods through the plant. Similarly, abrupt changes in the market price of inventory materials may have a pronounced effect upon the competitive position of any company. Because of this variable character of inventories, they may prove to be the vital weakness of large companies which on the surface appear to be successful and imposing business institutions.

The method by which companies value their inventories can have an

appreciable effect upon their earnings. Gross profit from sales is computed by deducting cost of the goods sold from net sales. The cost of such sales is computed by determining the cost of each item sold (or the cost of the various components processed into the sales item) from its value as carried in the perpetual inventory, or by adding all purchases during the current accounting period to the inventory valuation at the beginning of the year, and deducting from that total the value of the inventory carried at the end of the year. It was formerly the accepted practice to value inventories for balance sheet purposes at cost or market, whichever is lower, except in unusual circumstances which need not be detailed here. It can readily be seen from the foregoing that high inventory valuations cause an overstatement of earnings, create a false sense of working capital sufficiency, and frequently lead to excessive dividend and bonus distributions, as well as result in excessive tax payments. Understatement of inventory values, on the other hand, fails to disclose the real strength of the company.

The inventory valuation methods most commonly in use are (1) specific cost; (2) first-in, first-out (Fifo); (3) average cost; (4) last-in, first-out (Lifo); and (5) cost or market, whichever is lower. The first four methods are variations of actual cost. Specific costs are used when items can be identified and the cost paid for each is known, such as with individual pieces of jewelry, works of art, and the like. The Fifo method uses the most recent price paid for merchandise as a basis for valuation of the closing inventory, which results in inflated inventory values in periods of rising prices and understated values in periods of declining prices. By pricing closing inventory at the cost of the most recent acquisitions, it puts the oldest cost into the cost of goods sold during the period, which has the tendency to inflate earnings in periods of rising prices. The average-cost method involves the use of simple, weighted, or moving averages and is merely an attempt to price inventory at the average of prices paid over a period of time. Lifo is the reverse of Fifo and results in matching current costs against current revenue, so that earnings are less inflated by rising commodity costs. On the other hand, more profits are shown in periods of declining prices. As a rule, the valuation basis for inventory does not change despite fluctuations in prices, unless prices fall below the levels at which the basic inventory values are carried. The cost or market, whichever is lower, method of pricing is a combination of both actual and replacement cost (where replacement is below actual cost) and conforms to an old rule of conservative accounting to anticipate no profit and to provide for all possible losses. Inventory valuation reserves are also used to anticipate future declines as a result of style or technological change or other occurrences which could reduce inventory valuations. It is entirely a balance sheet valuation and provides protection against overstatement of the working capital position. In so far as it relates to the statement of earnings, any

actual losses sustained must be charged against current income and not against any reserves set up to cover such losses.

As the result of changing economic or internal operating conditions, companies often change their methods of inventory accounting. Such a change was effected in 1955 by the General Electric Company. The following excerpt from its *1955 Annual Report* states the reasons for the change, as well as give a simplified comparison of the effects of Fifo and Lifo.

The last-in-first-out, or LIFO, method of valuing inventories was adopted by the Company effective January 1, 1955. This method is based on the concept that a continuing quantity of inventory is necessary for the operation of a business. By maintaining this quantity of inventory at a constant price level, the higher costs of current replacements during periods of price increases are matched against current selling prices. As a result, earnings more nearly reflect the effect of current costs.

Costs of materials, especially copper, showed substantial increases during 1955, and future rises in costs of materials seemed probable. In addition, the employee program developed in 1955 provides for wage increases over a five-year period. The LIFO method was adopted because of the desirability of reflecting these increasing costs in the computation of current earnings.

In general, except for tungsten stocks, the first-in-first-out, or FIFO, method was used for inventories prior to 1955. A simplified comparison of the two methods during period of rising costs may be made as follows:

	Former Method: FIFO	*Present Method: LIFO*
Used for valuing inventory:	Higher current costs	Lower earlier costs
Charged against income:	Lower earlier costs	Higher current costs

During periods of rising costs the LIFO method results in lower inventory valuation. By matching higher current costs against current income, LIFO also results in lower income during periods of cost inflation. During periods of declining prices, the reverse is true.

As a result of this new procedure, the Company's 1955 net earnings were reduced $20 million. As previously mentioned, the LIFO method gives lower inventory valuations in periods of rising prices. As these lower valuations are put into effect, certain inventory reserves provided in prior years will no longer be required. Return of such reserves to income in 1955 approximately offset the effect on net earnings of the LIFO revaluation.[10]

The major objective in selecting a method for pricing inventory should be to choose the one that, under the circumstances, most clearly reflects periodic income. The considerations involved would be the physical na-

---

[10] General Electric Company, *1955 Annual Report*, p. 22.

ture of the inventory, the frequency and amplitude of price swings, the rate of inventory turnover, and the average size of the inventory. Reduced to concrete situations, it would appear that where sales prices are promptly influenced by changes in reproduction costs, the use of Lifo may be the more appropriate; where no such cost-price relationships exist, the Fifo or some average-cost method may be more properly used. In some cases, one method of valuation is applied to one portion of the inventory and another method to other portions of the inventory. As an illustration of the foregoing, the American Cyanamid Company at the end of 1960, carried its $94,808,390 inventory at the lower of cost or market. In general, cost is determined by either the "first-in-first-out" or "average cost" method, apart from certain inventories aggregating approximately $6,200,000, the cost of which is computed in accordance with the "last-in-first-out" method.[11]

THE AMOUNT OF WORKING CAPITAL

There are numerous factors which affect the working capital of a business, the appraisal of which assists management in formulating its policies and estimating its prospective requirements. At this point it is only necessary to mention some of what might be called the "normal" factors affecting, for instance, a manufacturing company. Significant among these are the general nature of the business, time consumed in manufacture, cost of product, turnover of inventories and accounts receivable, terms of purchase and sale, growth of business, and seasonal variations. In addition, there are the hazards and contingencies inherent in the particular type of enterprise, long-term trends in the industry, cyclical changes in the general economy, and, as we have seen, the size of the liquid resources desired by management as protection against contingencies of all kinds.

The effect of the general nature of the business on the working capital requirements is illustrated in Table 53 (p. 534), which shows the current assets as a percentage of the total assets for representative corporations selected at random from the three primary fields of activity—railroads, public utilities, and industrials. It is clear from this table that railroads and public utilities, with their large fixed investment, appear to have the lowest requirements for current assets. This is partly explained by the essentially cash nature of their business, which in the case of utility companies, permits a considerable diversion of working capital temporarily into fixed assets. However, the problems of working capital are not to be minimized in either of these fields of enterprise because ready funds are still essential to cover disbursements for wages, interest on funded debt, the purchase of materials and supplies, etc.

---

[11] American Cyanamid Company, *Annual Report, 1960*, p. 20.

For many years during and following the depression of the 1930's the principal object of most railroad managements was to preserve solvency. The major problem was to find sufficient working capital to maintain operations and achieve sufficient liquidity to meet necessary debt and other mandatory charges. As a result of the heavy expansion of business during and after World War II, the railroad industry as a whole has improved its working capital position considerably, although 1960 found several major roads in difficulties. While some managements still have a major problem in maintaining a current position sufficiently strong to permit vigorous operation, other managements have been able to ease this burden considerably.

TABLE 53

CURRENT ASSETS EXPRESSED AS A PERCENTAGE OF TOTAL ASSETS
SELECTED CORPORATIONS, DECEMBER 31, 1940, 1946, 1950, 1955, AND 1960*

Class of Corporations	1940	1946	1950	1955	1960
Railroads:					
New York Central Railroad Co.	4.3	11.4	11.3	10.9	7.8
Pennsylvania Railroad Co.	6.3	10.8	13.3	9.4	7.3
Southern Railway Co.	5.8	13.6	12.9	16.2	9.2
Public utilities:					
Holding companies:					
American Gas & Electric Co.†	14.8	9.4	11.7	10.4	7.2
Columbia Gas System, Inc.	7.6	12.3	6.0	16.1	15.5
Operating companies:					
Consumers Power Co.	8.5	12.1	5.9	9.5	6.1
El Paso Electric Co.	9.3	13.8	5.7	5.8	6.2
Public Service Electric & Gas Co.	7.8	12.0	9.7	5.7	5.8
Industrials:					
American Can Co.	41.2	41.5	39.0	45.7	39.9
Continental Can Co.	50.0	51.2	43.7	46.8	36.2
Chrysler Corp.	72.7	75.5	75.8	65.4	24.1
General Electric Co.	55.7	63.0	60.2	48.0	64.1
R. H. Macy & Co.	34.8	66.5	52.3	43.8	50.2
McCrory Stores Corp.	46.4	67.0	54.0	47.2	57.2
United States Steel Corp.	34.2	47.7	67.4	42.6	34.4
Westinghouse Electric Corp.	57.3	75.0	75.5	68.7	65.7

* *Moody's Manuals, 1941, 1947, 1951, 1956, 1961.*
† Name changed to American Electric Power Co., Inc., May, 1960.

Industrial concerns generally require a large amount of working capital, although this varies from business to business because of the lack of uniformity characterizing this field of enterprise. However, the underlying determinants of the amount are essentially the same as in the two previous groups. Where large amounts of fixed capital are required for operation, working assets may be expected to occupy a smaller niche in the asset structure. For similar reasons, a rapid turnover of capital

(sales divided by total assets) will inevitably mean a larger proportion of current assets. Looking to the underlying causes of these relationships, the following may be noted:

1. In the case of industries with large fixed investment, one of the primary uses of working capital is its conversion into operating plant structure. In turn, it is expected that the income realized from operations will normally replace such defections. This means that the flow of a portion of the working capital is circulated through fixed investment and that its recovery is dependent upon the income realized.

2. Where the current assets are relatively more important, a rapid sales turnover is usually found. Often, as in the case of retail concerns, the specific working assets are themselves the object of sale; and the recovery is direct and immediate. In manufacturing enterprises, a large share of the working capital is more likely to be changed in form by conversion into finished products; but, even here, the potentiality of recovery is not delayed as long as in the case of public utilities and railroads.

A second factor resulting in variation in working capital is the business cycle. During marked upswings of activity, there is usually need for larger amounts of capital to cover the lag between collections and increased sales and to finance purchases of additional materials to support the larger amount of business being done. Moreover, during the recovery and prosperity phase of the business cycle, prices of raw materials and wages tend to rise and require additional funds to carry even the same physical volume of business. In the downswing of the cycle, there may be a brief period when collection difficulties and declining sales cause embarrassment by the resulting failure to replenish the cash account. Later, as the recession or depression runs its course, the concern may find that it has a larger amount of working capital on hand than current business volume dictates.

The effect of price levels and business volume, discussed earlier in this chapter, is again demonstrated in Table 53. The change in the relative importance of current assets between 1940 and 1946 is striking in several cases. Generally, in those cases where there was no significant change, the rate of increase in fixed assets was considerably larger than the rate of increase in current assets. Substantially the same situation prevailed in the period between 1946 and 1950. The American Can Company, for instance, showed an increase of approximately 47 per cent in its fixed assets, while current assets increased 38 per cent. The Chrysler Corporation showed an increase of approximately 90 per cent in each category, leaving its ratios about the same for both periods. In the succeeding decade, American Can's total assets increased another $559,000,000 with the increase in current assets amounting to 147 per cent and new fixed assets to 167 per cent. In the same period, Chrysler's current assets increased 51 per cent while net fixed assets were up only 20 per cent.

BUDGETARY CONTROL OF WORKING CAPITAL

In the early part of this chapter, it was stated that the circular flow of working capital does not occur automatically and that it is the essential responsibility of management to guide it in proper proportions through the production machine. Efficient control of this process is provided by the working capital budget, which is, in effect, setting down the results of the careful measurement of future requirements and the plans formulated to meet those needs, in so far as they relate to working capital. In our discussion of the management of cash, it was indicated that the administration of cash entails more than control of working capital cash. Thus, the cash budget is distinct from the working capital budget, since it is designed to provide for all the needs of the business, including funds for the acquisition of fixed assets, payment of long-term loans, interest, dividends, and similar items. A working capital budget sets forth the estimated normal and seasonal current capital needs of the business and the plans to meet them as they arise. Various other operating budgets are used in connection with the preparation and execution of the working capital budget but are not a part of it.

Budget periods vary with the needs and character of the business. They usually are for a year and are based on forecasts that are normally for a longer period. The projections within the budget period are ordinarily for a month's time but can be varied with the particular circumstances. A budget, to be useful and practical, must be tailored to fit the needs of a particular company. Especially is this so since one of the primary purposes of a budget is to secure maximum profit from a minimum investment.

EXCESS OF WORKING CAPITAL

The question of the amount of liquid resources, i.e., cash and marketable securities, in excess of operating requirements, is primarily one for discusssion in connection with the management of working capital. While it is questionable whether the corporate universe employs an excessive amount of cash or working capital, there is a sufficiently definite trend among many companies to accumulate substantial amounts of liquid resources in excess of their known immediate requirements to justify a separate consideration of this phenomenon. This tendency to hold large liquid reserves sharpens a distinction that should be made between "true" working capital and the excess working capital held as a margin of protection to meet any contingency or needs which might arise in the future. There is always some portion of true working capital which is not a part of the circulating capital, such as cash holdings to provide minimum bank balances, or Treasury notes held for tax-payment pur-

poses. But true working capital can always be computed as a function of the transaction requirements of the business. The additional amount to be held as a fund to meet emergencies is a variable determined by estimate.

Many managements believe that working capital should keep "working." Other managements, however, have steadily built up substantial amounts of cash and marketable securities in excess of normal needs of the business. This is an outgrowth of the experience suffered by many companies in the post-World War I depression as well as in the depression of the thirties. As a result of such experiences, many companies, particularly the larger organizations, took advantage of the prosperous period of the twenties to build up substantial amounts of cash and marketable securities. This was accomplished in part through retention of an increased portion of the large earnings received during this period and in part through the sale of large amounts of their own securities during the era of the extensive rise in security prices. Many companies entered the depression period of the thirties with little or no debt. Other companies, not so foresighted or so fortunate, met with severe losses as they were called upon to liquidate their indebtedness. The costly lessons learned in the two depression periods still serve as guideposts for many managements and explain why many corporations have used current bank debt sparingly, if at all—although they have turned to term debt in many instances—and why they maintain larger reserves of cash than the ordinary transaction needs of the business would seem to require. The use of the word "seem" in the previous sentence is advisable. Changing conditions modify previous attitudes.

In the immediate postwar years companies which had ample cash funds, could readily meet the costs of conversion. They also could take full advantage of the surging business and consumer demand for peacetime goods. Then, too, for a few years retroactive increases in tax rates, awards of substantial back-pay raises and damage claims, substantial fluctuations in prices over a short-term and rapid technological changes all came to be regarded as almost commonplace. For many industries, the latter two factors still continued as recurrent problems in the mid-fifties. Other influences on cash policy, as we have seen, have been the growing use of business and consumer credit. At all events, many managements, particularly those of large, well-financed companies, regard these factors of greater importance than the arguments advanced against the maintenance of a substantial cash position. While experience has validated the position of many such managements, they still have the problem of not permitting excess cash to unbalance their operations to the extent of uneconomic use of capital. In general, a condition of reasonable balance in the business structure means an ability to keep current in paying liabilities and in providing maximum earnings upon investment. In this respect, the business machine may be likened to most mechanisms—

proper functioning occurs only when the component parts are in correct balance.

QUESTIONS AND PROBLEMS

1. Discuss the relationship between the asset structure and the methods used for raising funds.
2. "The net working capital concept places emphasis upon an intangible differential which reflects the relative security or soundness of the working capital position." Explain.
3. Discuss the possible conflict between security and earning power in the maintenance of a strong cash position.
4. Do you think that part of the inventory may be considered, for all practical purposes, as a fixed asset?
5. Why may the inventory position play an important part in determining the financial soundness of a corporation?
6. Study the trend in inventory position of any two comparable companies of your selection, and comment on the results.
7. Prepare a chart showing the trend of copper prices since 1940, and note the inventory trends of any two copper companies during the same period. Explain the fluctuations, and indicate what you expect the future trend to be. Investigate the use of Lifo by the companies you select.
8. Relate your copper price data to the inventory position of one or more large copper *using* or consuming companies.
9. Discuss the propriety of using long-term financing media to accommodate short-term needs.
10. "The fate of large investments in fixed capital is often determined by a relatively small amount of current assets." Comment.
11. "The working capital position is affected more by business conditions and trends than by the nature or size of the company." Discuss.
12. Study the effect of war and postwar conditions on any two comparable companies of your selection.

REFERENCES

BUCHANAN, N. S. *The Economics of Corporate Enterprise*, chap. vi, Part III. New York: Henry Holt & Co., Inc., 1940.

BURTCHETT, FLOYD F., and HICKS, CLIFFORD M. *Corporation Finance*, chap. xxviii. 3d ed. New York: Harper & Brothers, 1959.

DEWING, A. S. *Financial Policy of Corporations*, chap. xxiii. New York: The Ronald Press Co., 1953.

GERSTENBERG, CHARLES W. *Financial Organization and Management*, chaps. xix and xx. 4th rev. ed. Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1959.

HOWARD, BION B., and UPTON, MILLER. *Introduction to Business Finance*, chaps. viii–xii. New York: McGraw-Hill Book Co., 1953.

LUTZ, FRIEDRICH A. *Corporate Cash Balances, 1914–1943*. New York: National Bureau of Economic Research, Inc., 1945.

OSBORN, RICHARDS C. *Corporation Finance*, chap. xvi. New York: Harper & Brothers, 1959.

SCHMIDT, CHARLES N., and YOUNG, RALPH H. *The Effect of War on Business Financing*. New York: National Bureau of Economic Research, Inc., 1943.

Chapter 27 ►

SOURCES OF WORKING CAPITAL

UP TO THIS point, our attention has been directed to the nature and use of working capital as an integral part of corporate operations. Of equal importance is the means by which working capital requirements are financed. Unlike fixed assets, where values are frozen and their liquidation or conversion spreads over many years, the problems of working capital financing relate to a highly variable and easily realized form of asset. Likewise, it is a form of asset which may be easily dissipated and lost. The highly fluid feature invites specialized financing because of the potential recovery of the funds; but, at the same time, this fluidity may make it difficult to provide all working capital through some form of long-term financing.

While a portion of the working capital requirements of the business should ordinarily be obtained through the sale of stocks in the original financing, it is unusual for all the working capital to be obtained in this way. Other sources will be used so that proper balance may be maintained between the expected period of the use of the funds and the retirement of the financial obligation. Thus, a sharp distinction may be drawn between the amount of working capital which is needed more or less permanently and that which is required for peak periods of operation. The former may quite properly be raised by the use of long-term financial media, or permanent financing, whereas the latter invites only short-term or current financing.

The various sources of working capital have been classified broadly as (1) permanent and (2) seasonal, or current. Permanent financing involves no immediate maturity date, whereas current financing usually entails a maturity under one year.

PERMANENT FINANCING

Stocks. A portion of working capital needs should be accommodated by the sale of stocks. This should be an amount equal to the normal

working capital requirements anticipated at the time of organization. The use of stock to obtain initial working capital places the corporation on a sound basis and enables it to provide more adequately for later needs by other means. As stated previously, the elements of working capital are highly variable; and there is difficulty in maintaining the proper flow of values through the various accounts and in avoiding diversions to fixed capital uses. The portion of working capital obtained through the sale of stock provides important relief to management against these contingencies because there is no fixed maturity date which must be met or any addition to interest charges, which exist as obligations regardless of earnings.

The greater flexibility provided by the use of common stock makes it a tempting substitute for current debt whenever the opportunity is present. Thus, when stocks sell at high levels, such as prevailed in the late '50's and early '60's, companies are encouraged to raise funds with new stock issues and retire outstanding current indebtedness. In any such period, a higher-than-average amount of working capital will be provided by permanent sources. Evidence is usually found in abnormally large cash balances and/or holdings of short-term government securities. This condition emphasizes the fact that working capital should not be obtained through permanent financing unless the need can itself be regarded as reasonably permanent. Temporary expansions in working capital assets due to boom conditions should be financed on a current basis, with due regard for adequate liquidity and ability to retire the indebtedness.

Accumulated Surplus. The common practice of retaining earnings in the business as accumulated surplus affords another proper method for obtaining working capital. Corporations ordinarily do not pay out all of their earnings as dividends over any period of years. This practice is followed because successful corporations constantly grow in size and volume and have constantly larger needs for capital. Rarely does a concern maintain static conditions for any long period of time.

Bonds. In comparison with stocks and surplus, bonds involve certain difficulties as a source of working capital funds. In the first place, bonds give rise to fixed charges which must be paid regardless of the condition of earnings. If a portion of the working capital should be idle, not only would earnings be lost, but also it would be necessary to pay a penalty in the form of interest on the bonds. For this reason, it is doubly important to use bonds for working capital purposes only where the requirements are believed to be permanent and never for any seasonal or temporary purpose.

In the second place, bonds have a definite maturity. During the years immediately following the issuance of bonds, the due date may appear to be unimportant; but the future contingencies are definitely increased. Like bonds, the various forms of current indebtedness also have due dates; but these are relatively small in amount and frequent in their occurrence.

Management must pay such obligations more or less regularly and is under a constant discipline as a result. Because of the contingencies arising from the use of bonds, there is merit in financing normal working capital needs with common stock and temporary needs from current sources. This will reduce the risk of bond default and provide a degree of flexibility as well.

Sale and Lease Back. A financing method that entails a long-term obligation and is not yet a bond is the so-called "sale-and-lease-back" form of contract. Under this method a company can sell certain of its property to an institutional investor, and then lease it back for a term of twenty to fifty years. In the case of new buildings, such as stores, office buildings or factories, the investor, usually an insurance company, college, or pension fund, can build the structure to the specifications of the lessee. In the first instance, the company secures cash for working capital and other uses; in the second it avoids an outlay of funds or the necessity of borrowing. Under the terms of the usual lease, the company pays a fixed net rental; and assumes all operating expenses; including maintenance, insurance, and real estate taxes. The net rental includes an amount for amortization of the investor's investment. These payments of course constitute a fixed obligation on the lessee.

Although this method of financing had its initial popularity with merchandising organizations, it has not been confined to such type of company. Along with such companies as Sears, Roebuck & Co., Montgomery Ward & Co., R. H. Macy & Co., and Lit Brothers, the Continental Can Company and the Fruehauf Trailer Company, Inc., have used this form of financing to advantage.

A variation in form more than substance occurs when the lessee corporation arranges with the financing organization (frequently an insurance company) to purchase specialized equipment and then lease it to the using corporation. In this case, the leasing company is obtaining physical assets without a drain on working capital rather than converting fixed assets to working-capital uses. An illustration is the recent Eastern Airlines–Prudential Insurance deal signed in 1960.

Eastern had arranged for the purchase of Boeing and Douglas jet aircraft to be delivered during 1961–65 at an estimated cost of $260,000,000. Under the 1960 lease, Eastern agreed to lease ten additional jets from Prudential for ten years beginning with delivery dates late in 1961 at aggregate annual rentals of $6,420,000 payable semiannually. Under the terms of the agreement, between Eastern, Boeing Aircraft Company, United Aircraft Company, and Prudential Insurance, the insurance company bought Eastern's outstanding purchase contracts for the aircraft and engines, and agreed to lease such equipment to Eastern. The agreement also provided that Prudential would pay a total of $47,740,000, with Eastern required to pay any excess. Eastern may at the lessor's option, purchase the equipment at the expiration of the lease for 10 per cent of

the original cost or $4,775,000 whichever is lesser. The lease may be renewed for three years, if the lessor agrees.[1]

Amount of Permanent Financing to Be Used. From the viewpoint of management convenience, there would be much to say for providing all working capital from permanent financing—particularly from stocks and retained earnings. There would be no due dates to meet and no interest to be paid. During times of slack business, cash would accumulate; and during peak periods, cash would be reduced as it was converted into other current assets. No business decision would need to be conditioned by the availability of funds. Such a situation may exist in some companies at some periods, but it is hardly a normal or desirable condition.

As stated earlier, only the normal or usual working capital requirements should be provided from permanent funds. The current assets of most concerns fluctuate from day to day, from season to season, and cyclically. Any year may bring a new expansion in business, a new emergency outlay of funds, a new peak cash requirement. Permanent financing to meet such contingencies would mean increased costs—directly in terms of interest or indirectly in idle assets not devoted to any productive purpose. Moreover, long-term investors prefer to have the bulk of their investment supported by relatively permanent assets.

For reasons such as these, it is generally considered sound practice for the corporation to limit its permanent financing of working capital requirements to its normal or usual needs. If a concern finds that its current assets fluctuate between $200,000 and $500,000, with $300,000 the usual low point, it should endeavor to provide permanent funds to cover the last amount. To provide the peak amount would be wasteful; to cover only the extreme minimum might be dangerous.

CURRENT FINANCING

It is generally considered sound practice for a corporation to provide its temporary or fluctuating working capital requirements from current

TABLE 54

MAJOR COMPONENTS OF CURRENT LIABILITIES OF ALL U.S. MANUFACTURING COMPANIES, AS A PERCENTAGE OF CURRENT LIABILITIES AND CURRENT ASSETS, 1956–60*

	1956		1957		1958		1959		1960	
	C.L.	C.A.	C.L.	C.A.	C.L.	C.A.	C.L.	C.A.	C.L.	C.A.
Short-term bank loans (one year or less)	13.4	5.7	14.1	5.8	12.7	4.8	12.7	5.1	14.8	5.9
Other notes and accounts payable	35.8	15.2	35.0	14.3	38.7	14.7	38.3	15.3	37.9	15.1
Federal income taxes accrued	24.6	10.4	22.4	9.1	19.2	7.3	20.6	8.2	17.7	7.1
Other current liabilities	26.2	11.1	28.5	11.7	29.4	11.2	28.4	11.2	29.6	11.7
Total current liabilities	100.0	42.4	100.0	40.9	100.0	38.0	100.0	39.8	100.0	39.8

* Federal Trade Commission and Securities and Exchange Commission, *Quarterly Industrial Financial Report for United States Manufacturing Corporations: 1956–60.*

[1] Eastern Airlines, Form 10K, filed with S.E.C., Washington, D.C., May 1, 1961.

sources. The sources from which such temporary needs are financed are frequently thought of only in terms of the various types of credit suppliers. However, internal operations of a business are also a source of current capital. The relative importance of the internal and external sources of temporary funds varies from company to company, from industry to industry, and from stage to stage of the economic cycle. The extent to which working funds are obtained through current financing from outside sources is dependent primarily upon the original permanent financing, the stability of the company's sales as well as their degree of uniformity throughout the year, the practices prevailing in the industry, and the amount of cash available from the company's own operations.

Table 54 presents the major elements of the current liabilities of all the manufacturing companies in the United States, as a percentage of total current liabilities and total current assets, as of the end of selected

TABLE 55

SOURCES AND USES OF CORPORATE FUNDS, 1956–60*

(Billions of Dollars)

Source or Use of Funds	1956	1957	1958	1959	1960†
Uses:					
Plant and equipment outlays	29.9	32.7	26.4	27.7	31.0
Inventories (book values)	7.6	2.1	−3.3	5.3	2.0
Customer net receivables‡	3.3	2.1	4.3	4.3	5.5
Cash and U.S. government securities	−4.3	−.3	3.5	3.8	−3.5
Other assets	3.0	1.3	.9	4.2	5.0
Total uses	39.5	37.8	31.8	45.3	40.0
Sources:					
Internal:					
Retained profits and depletion allowances	10.5	8.9	6.1	9.1	6.5§
Depreciation and amortization allowances	17.3	19.1	20.2	21.5	23.0
Total internal sources	27.8	28.0	26.3	30.6	29.5
External:					
Federal income tax liability	−1.7	−2.2	−2.4	2.4	−1.5
Other liabilities	3.0	2.1	−.1	1.9	1.5
Bank loans and mortgage loans	5.4	1.7	−1.0	3.8	3.5
Net new issues	7.9	10.6	9.5	8.0	8.0
Total external sources	14.6	12.2	6.0	16.1	11.5
Total sources	42.4	40.1	32.2	46.8	41.0
Discrepancy (uses less sources)	−2.9	−2.3	−.5	−1.5	−1.0

Source: *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, January, 1961), Table C-60, p. 196. Detail will not necessarily add to totals because of rounding.

* Excludes banks and insurance companies.

† Preliminary estimates.

‡ Receivables are net of payables, which are not shown separately.

§ Preliminary estimates by Council of Economic Advisers.

years 1956 through 1960. The figures reveal the relative importance of the various current liability categories as sources of temporary working capital and their ultimate claim on the current assets. While the data cannot be taken as typical of any one company, they do indicate the importance of liability items as a source of temporary financing. When paid, expenses necessarily become a drain on the cash accumulated during the preceding period of accrual; but until disbursed, the funds obviously constitute part of the working capital.

The manner in which all corporations, other than banks and insurance companies, secured and used their funds during 1956–60 is set forth in Table 55. While, as indicated earlier, it is impossible to identify specific uses of funds with specific sources, it is obvious that additions to the various types of working capital have been one of the important uses of funds. Likewise, it is clear that internal sources as evidenced by retained earnings and capital recoveries through depletion and depreciation have constituted important sources of funds.

INTERNAL SOURCES

Basically, the only true internal source of working capital is found in earnings. First, this is effected by financial policy which provides for the retention of earnings in the business. As noted previously, such funds may be utilized for either permanent or temporary need. Second, working funds are provided by noncash expenses and by the accrual of various expense items. Unlike accounts payable and notes payable, noncash expenses do not represent a sure and immediate *quid pro quo;* nothing has been received by the company as a direct offset to the charge. The manner in which expense accounts serve as a source of funds may be seen in the ensuing analysis of depreciation and taxes. Although taxes are an obligation to outsiders and in that respect different from earnings and capital recoveries, they are generated from within the company by its operations. For this reason, taxes may be more properly classed as an internal source, rather than external, as in Table 55.

Depreciation. As was explained in the previous chapter, provision for depreciation of fixed assets constitutes a part of the cost of production or of any business operation and, consequently, represents an expense that is chargeable against earnings. Unlike most expenses, however, it does not represent a cash outlay and so is referred to as a "noncash" expense. As a result of this accounting procedure, the company has capital in an amount equivalent to the depreciation provision charged against earnings. This is true, of course, provided that the company has earnings equal to all its expenses, including the provision for depreciation, and provided that the company has realized the necessary amount of cash from its operations. The purpose is to provide for the ultimate replacement of the depreciating asset. To the extent that this is not done currently, the company has the use of the cash so generated for such purposes as it sees fit.

Replacement of assets can be deferred for only so long; for, sooner or later, the company must replace the depreciated asset, or provide its equivalent, either from the temporarily withheld funds or from other sources. In the meantime, however, it has the use of such funds, which in the case of companies with heavy fixed asset investment, are quite substantial. This is especially so among companies which have been granted certificates for accelerated depreciation, or "fast write-offs" for certain types of so-called defense facilities.

Accrued Taxes. State and federal income taxes are payable at stated intervals of varying lengths of time subsequent to receipt of the income on which they are calculated. Furthermore, certain taxes which companies are required to collect for various taxing authorities, including federal excise and state sales taxes and payroll withholdings of employee taxes, are not transmitted for periods varying from a month to three months. The company has the use of such funds in the interval, indicating its obligation by an accrual for taxes or a reserve. The significance of such funds for some companies is indicated in both Table 54 and Table 55.

Formerly, a company could, in effect, have the use of funds required to pay its federal income taxes over the course of a full year, since income taxes could be paid quarterly in the year subsequent to the year of income or taxable year. However, as we observed in the preceding chapter, companies with very heavy tax payments frequently provide for payment of a large portion of such taxes through investment in United States government securities. As a consequence, an amount of cash almost equivalent to the accrued tax is tied up, although the company does receive a small interest return on its money. For companies that do not have such heavy tax burdens and have fairly uniform earnings, the funds represented by tax accruals can form a fairly stable part of their working capital. In 1950, the tax law was changed to provide for the gradual acceleration of the tax so that, by 1955, half of the taxes due on the preceding year's profits would be payable on March 15 and half on June 15. Later, amendment to the law provided further acceleration so that by 1959, all corporations earning in excess of $100,000 were on a 100 per cent current basis. In other words, in 1959 all corporations with estimated earnings for 1959 in excess of $100,000 were required to pay estimated taxes on those earnings quarterly during the year 1959. The drain of such provisions on the working capital of corporations during the transition period was substantial. Some conception of this amount may be gleaned from the fact that corporate taxes amount to approximately $22,000,000,000 per year.

EXTERNAL SOURCES

External sources of temporary financing are numerous. Some sources are used more or less regularly under a continuing relationship; others are resorted to only when temporary or emergency needs must be met.

Our discussion will be limited to the principal sources, indicating briefly how each is used.

TRADE CREDITORS

Most business between industrial and mercantile establishments is conducted on a credit basis. The customary terms may vary from a few days to a few months, and it is common practice in many industries and trades to grant cash discounts for prompt payment. Corporations may therefore raise a part of their working capital by trade credit, which is extended by the concerns from which raw materials and other supplies are purchased. Offset against trade creditors as a source of working capital is the volume of trade credit which must be extended to the concern's own customers. When the corporation is buying on short terms and selling on long terms, the accounts receivable will necessarily exceed the accounts payable. In such a case, there is a differential against the company which must be financed by other sources. If, however, the reverse is true, the company may be able to obtain a considerable portion of its current financing from its trade creditors. How important this can be is indicated in Tables 54 and 55. Table 55 unfortunately does not show the gross picture. The changes in the accounts receivable and accounts payable relationship are shown net. However, as we have previously pointed out, there has been a marked institutional change in the increased securing and granting of both trade and customer credit.

Another important factor relates to the cost of using trade creditors rather than other sources for current funds. It is a common practice in many industries to offer trade terms of 2 per cent 10, net 30 days, although, in some cases, the cash discount periods may be longer. In the furniture industry, for instance, the terms are frequently 2 per cent 30, net 60 days. In either case, the business has the problem of deciding whether to raise the necessary cash through some other form of financing, such as borrowing from banks, or simply to regard the trade creditors as a logical source of funds for which the business incurs financial costs in the form of cash discounts not taken. Ordinarily, it is much more profitable to take advantage of cash discounts, even though it may be necessary to borrow the funds from other agencies. The business that is operating under 2 per cent 10, net 30 days terms and does not take its cash discounts is, in effect, paying 2 per cent for the use of the funds for 20 days or an interest rate of 36 per cent a year. As a consequence of this high rate of interest paid by the firms that do not take advantage of the discount, the credit standing of such firms may be impaired.

When consideration is given to the cost of funds, the amount of working capital obtained from trade creditors may be said to be only the amount of money or value which is contained in accounts payable within the discount period. Even this may be in many cases a rather important

sum. For example, as of December 31, 1960, the Allied Chemical Corporation had accounts payable and accrued liabilities amounting to $88,597,-283. At the same time, its current assets totaled $286,193,694. Thus, the company was obtaining approximately 31 per cent of its gross working capital from creditors. As of the same date, the company was financing customers to the extent of $88,762,772. The fact that accounts receivable and accounts payable were nearly equal does not detract from accounts payable as a source of working capital. Presumably, the company would have had to finance customers to this extent in order to achieve the desired volume of business. If no funds had been obtained from its trade creditors, then the entire $88,762,772 would have had to be acquired from some other source.

Occasionally, companies doing a strictly cash business are found which have virtually no accounts receivable but have considerable amounts in accounts payable. G. C. Murphy Co. reported as of December 31, 1960, no accounts receivable, but it had accounts payable of $2,812,629. As of the same date, total current assets amounted to $56,514,034. In other words, the company was obtaining 5 per cent of its working capital from trade creditors.

COMMERCIAL BANKS

The corporation may make continuous use of the lending facilities of commercial banks. While bank borrowings should ordinarily be the source for a large portion of the extraordinary or temporary working capital needs, they may also be used for obtaining a portion of the ordinary current financing. This has the advantage of developing established financial connections for use in times of emergency or of having a ready means of reducing working capital during periods of extreme decline in the volume of business. If the company regularly obtains a portion of its normal working requirements from banks, the bank borrowings may be paid off in periods of business recession to reduce both the assets and the liabilities of the business. If the funds are all represented by stockholders' equity or long-term debt, the company will necessarily have excess funds, which invite extraneous use if they are not to be the cause of waste by remaining idle.

Prior to 1929, corporations regularly obtained a large portion of their working capital through bank borrowings. In fact, a considerable amount of permanent or long-term capital was supplied by commercial banks because of agreements to renew short-term notes or through loans on demand notes made with the understanding that they would not be called. However, during the 1928 and 1929 boom, large amounts of common stock were sold to provide additional working funds; and, as a consequence, for many years corporations did not make as great use of the commercial banks as was formerly true. As of June 30, 1929, the member

banks of the Federal Reserve System had loans outstanding in the amount of $26,150 million and had security investments, chiefly governments, of $9,784 million. The volume of bank loans shrank materially during the depression; even by the end of the recovery year, 1940, they had increased to only $15,321 million. In contrast to this figure of only a little over half the 1929 total, security investments had more than doubled to $21,805 million. It is difficult to determine how much of this change was due to the financing policies of business and how much to the influence of federal fiscal policies coupled with the banks' search for relatively risk-free investments, but we may reasonably infer that both factors were important.

In the years from 1940 to the end of 1946, bank loans expanded to $26,696 million, whereas security investments increased to $69,666 million. Although nearly half the increase in bank loans occurred in the commercial-loan classification, such loans had not returned to their 1929 importance if any allowance for the relatively larger volume of industrial and business activity is made.

After World War II, a marked reversal occurred. Loans including commercial loans, became increasingly important in the portfolios of the member banks. The change was fairly gradual in the period 1946–50. It became more pronounced as the decade of the 1950's advanced. At the end of 1946 loans of all kinds constituted about 28 per cent of total loans and investments of the member banks. At the end of 1955 loans constituted around 53 per cent of the category of working assets. Expressed another way, on December 31, 1946, loans approximated 21 per cent of total assets of the member banks. At the end of 1955 this percentage had increased to 40 per cent. Approximately 44 per cent of this latter total was represented by assets in the commercial-loan classification. At the end of 1960, commercial loans were about 40 per cent of all loans which in turn amounted to about 46 per cent of total assets of member banks.

Prior to 1946, detailed data had always been lacking on commercial bank lending to business classified by term of loan, type and form of business, size of business, and similar categories. In that year, the Federal Reserve Board made a study of the loans outstanding on the books of member banks as of November 20. The study covered such questions as the amount of loan outstanding, term of loan, repayment method, interest rate, type of business of borrower, his total assets, and his form of organization. In 1955 the Federal Reserve Board made another study along similar lines, covering loans outstanding on the books of member banks as of October 5.[2] Table 56 shows, in comparative form the business loans

[2] *Federal Reserve Bulletin*, March, 1947, p. 263, and *Federal Reserve Bulletin*, April, 1956, p. 327. Both studies furnished the basis for a series of articles in the *Federal Reserve Bulletin*. The initial article on the 1946 study began in the March, 1947 issue of the *Bulletin;* the first article on the 1955 study appeared in the April, 1956 issue of the *Bulletin*. Subsequent installments appeared in June, 1956, April and September, 1959.

of member banks, 1955 and 1946, by business of borrower. As may be noted, the dollar amount of business loans outstanding in 1955 was about 2⅓ times as large as in 1946, and the number was twice as large.

TABLE 56

BUSINESS LOANS OF MEMBER BANKS, 1955 AND 1946, BY BUSINESS OF BORROWER*
(Estimates of outstanding loans)

Business of Borrower	Amount of Loans				Number of Loans			
	In Millions of Dollars		Percentage Distribution		In Thousands		Percentage Distribution	
	1955	1946	1955	1946	1955	1946	1955	1946
All businesses	30,820	13,189	100.0	100.0	1,317	673	100.0	100.0
Manufacturing and mining, total	11,283	5,650	36.6	42.8	225	116	17.1	17.2
Food, liquor, and tobacco	1,838	1,536	6.0	11.6	36	18	2.7	2.7
Textiles apparel, and leather	1,689	484	5.5	3.7	31	16	2.3	2.4
Metals and metal products	3,235	1,629	10.5	12.4	59	29	4.5	4.3
Petroleum, coal, chemicals, and rubber	2,646	1,061	8.6	8.0	28	13	2.2	1.9
Other	1,875	939	6.1	7.1	72	40	5.4	5.9
Trade, total	6,539	3,883	21.2	29.5	517	341	39.2	50.7
Retail	3,476	1,472	11.3	11.2	411	253	31.2	37.6
Wholesale†	3,063	2,411	9.9	18.3	105	88	8.0	13.1
Other, total	12,998	3,656	42.2	27.7	575	216	43.7	32.0
Sales finance companies	2,872	779	9.3	5.9	13	7	1.0	1.0
Transportation, communication, and other public utilities	2,906	1,222	9.4	9.3	44	38	3.4	5.6
Construction	1,691	446	5.5	3.4	105	43	7.9	6.4
Services	1,783	490	5.8	3.7	239	76	18.2	11.3
Other nonfinancial‡	3,745	719	12.2	5.4	174	52	13.2	7.7

Source: *Federal Reserve Bulletin*, April, 1956, p. 329. Footnotes are those appended to the Table in the *Bulletin*. Details may not add to totals because of rounding.

* Data for 1946 were reported in "Business Loans of Member Banks," *Federal Reserve Bulletin*, March, 1947. Additional articles summarizing the results of the 1946 survey appeared in the May, June, July, and August, 1947 issues of the *Bulletin*.

† Totals for 1955 include 8,900 loans to commodity dealers amounting to $751 million. These loans were included in wholesale trade in 1946 and not separately reported.

‡ Totals for 1955 include 75,600 loans to real estate concerns amounting to $2,405 million. These loans were included in "all other" in 1946 and not separately reported.

Unsecured Banks Loans. The traditional and still common way of using commercial banks is by means of the unsecured promissory note. The term of such a loan is ordinarily less than a year and usually is for 90–180 days. The sole security is the general credit standing of the borrowing corporation. In event of failure, such loans follow the secured claims and share equally with the other general claims.

The usual practice is for the corporation to establish a "line of credit" with a commercial bank prior to the time the funds will be needed. Es-

tablishment of a line of credit does not bind the bank legally to make a loan at the time requested, if conditions have changed. But the bank seldom fails to honor its agreement unless circumstances have changed drastically, since it does not wish to incur the bad relations which might result from such action. Under normal arrangements, the line of credit establishes the amount and the terms upon which the bank will advance funds as required. The amount may vary from a few hundred dollars to millions, depending upon the size of the borrowing concern and its credit condition. Whatever the amount, the arrangement is a highly desirable one for the corporate management to the extent that it provides funds when needed, quickly, and without complicated financial process. The limitation to this procedure usually hinges on the question of adequacy. Can enough funds be obtained in this way to cover the fluctuating portion of working capital requirements? Will such funds also be available with any certainty in times of financial crisis?

The adequacy of a line of credit depends upon two important factors. One is the general financial strength of the corporation; the other is the size and lending policies of the bank. A corporation having a well-balanced financial position, with the fixed assets and a portion of the current assets financed on a long-term basis, and with evidence of sound management, should be able to borrow a substantial part of its current requirements on an unsecured basis. However, banks differ materially in the liberality of their credit extensions and in their lending capacity. One bank will act favorably on a loan application regarded as unfavorable by another bank. Some banks look with favor upon loans for short-term or seasonal needs; others are willing to lend for longer periods but require some form of security.

A bank's lending capacity is limited both by management considerations and by law. Sound banking requires a reasonable diversification of loans both for a spreading of risk and for a scheduling of maturities. Banking laws endeavor to enforce a measure of sound bank management by limiting the size of individual loans. The statutes governing national banks limit the amount that can be loaned to any one borrower to 10 per cent of the bank's capital stock and surplus.[3] State banking laws differ but, in general, are similar to the federal law on this point.

This makes it important for the corporation to select its banking connections with considerable care. The bank selected should be interested in the corporation's line of business. It should have a known lending policy so that its attitude toward special situations can be forecast. It should have adequate lending limits or satisfactory correspondent relations to provide the necessary lending capacity. As a rule, large corporations will patronize the larger banks; whereas small corporations will

[3] Larger amounts can be advanced upon certain types of security, but it is probable that the 10 per cent limitation is usually the effective one. U.S. Revised Statutes, sec. 5200.

use the smaller banks.[4] In all probability, the small corporations will find not only that the small banks can render adequate loan service but also that the small banks will be more interested in their problems.

Secured Bank Loans. When the internal position of the corporation is such that an inadequate amount of unsecured bank credit can be obtained, the corporation may turn to the use of secured loans. Banks will advance funds on notes secured by endorsement or co-makers; inventories; equipment; plant or other real estate; stocks, bonds, and mortgages; and accounts receivable, to name some of the more significant methods. Table 57 gives a summary of the extent to which these and other methods of providing loan security were used in late 1955.

TABLE 57

BUSINESS LOANS OF MEMBER BANKS BY TYPE OF SECURITY, OCTOBER 5, 1955*

Type of Security	Amount of Loans		Number of Loans	
	In Millions	Percentage Distribution	In Thousands	Percentage Distribution
Unsecured	$15,105	49.0	386.1	32.6
Secured	15,700	51.0	799.1	67.4
All Loans	$30,805	100.0	1,185.2	100.0
Secured:				
Endorsed or co-maker†	$ 2,755	17.5	185.9	23.3
Assignment of claims‡	2,813	17.9	52.9	6.6
Inventories§	1,448	9.2	47.4	5.9
Equipment‖	2,194	14.0	218.5	27.3
Plant and other real estate	3,592	22.9	164.4	20.6
U.S. Government securities	182	1.2	8.5	1.1
Other bonds	165	1.0	0.9	0.3
Stocks	1,002	6.4	39.1	4.9
Life insurance and savings accounts	447	2.8	53.8	6.7
Other security	1,102	7.0	26.1	3.3
All Secured Loans	$15,700	100.0	799.1	100.0

* *Federal Reserve Bulletin*, September, 1959, p. 1119.
† Includes nongovernment guarantee.
‡ Includes assignment of contracts, accounts receivable, and oil runs.
§ Includes trust receipts, warehouse receipts, and factors' liens.
‖ Includes assignment of title and chattel mortgages.
Note: Details may not add to totals because of rounding.

Several items in Table 57 are worthy of special note. In the first place, the *amount* of secured loans outstanding at the time of the study was approximately equal to the amount of unsecured loans. The *number* of secured loans was more than twice the number of unsecured loans. In other words, security is more of a characteristic of small loans to small companies than of larger loans made to larger companies. This is shown more clearly by Table 58 where it may be observed that in nearly every

[4] *Federal Reserve Bulletin*, April, 1956, p. 331.

category of industry, security becomes less prominent as size of the borrower increases. Small companies often complain about this situation, but it cannot be denied that stability and certainty of repayment increase with size of firm.

In the second place, four categories of security account for over 70 per cent of the amount and over 80 per cent of the number of loans.

TABLE 58

SECURED LOANS AS A PERCENTAGE OF ALL MEMBER BANK BUSINESS LOANS OUTSTANDING TO BORROWERS CLASSIFIED BY SIZE AND TYPE OF BUSINESS, OCTOBER 16, 1957*

Business of Borrower	All Borrowers	Size of Borrower (Total Assets, in Thousands of Dollars)						
		Less than 50	50–250	250–1,000	1,000–5,000	5,000–25,000	25,000–100,000	100,000 and over
	Amount							
All businesses	50.3†	78.4	76.5	72.1	59.9	45.0	28.2	17.5
Manufacturing and mining	37.5	78.0	75.0	67.7	52.7	36.9	26.0	11.1
Trade:								
Wholesale‡	60.5	72.1	71.7	66.6	54.5	44.0	47.0	65.8
Retail	63.6	74.8	72.7	70.9	56.7	35.5	21.6	49.7
Other:								
Sales finance	17.8	74.3	78.5	72.9	43.6	18.8	5.2	0.8
Transportation, communication, and other public utilities	46.7	90.6	85.0	86.3	74.2	62.4	34.6	27.3
Construction	67.9	72.1	72.6	73.4	71.6	44.5	26.8	51.4
Real estate	87.1	89.1	88.1	84.7	85.2	89.0	82.8	62.8
Service	70.0	81.8	81.9	76 6	68.3	38.5	26.2	11.1
All other nonfinancial	71.5	82.4	78.3	73.4	67.2	70.7	54.9	52.3
	Number							
All businesses	66.8	68.2	65.7	65.9	60.7	48.5	31.7	34.7
Manufacturing and mining	66.0	70.1	67.8	66.7	56.7	36.0	22.1	20.1
Trade:								
Wholesale‡	63.1	65.0	62.5	62.2	59.0	58.8	56.5	65.2
Retail	63.1	64.4	60.9	59.5	57.6	46.4	30.0	72.1
Other:								
Sales finance	46.4	66.9	70.6	62.2	35.7	18.9	9.6	4.8
Transportation, communication, and other public utilities	81.4	86.4	80.9	81.6	78.5	61.4	41.6	48.8
Construction	65.9	62.5	65.4	70.3	68.3	61.7	28.5	75.6
Real estate	77.1	79.2	76.4	73.4	73.0	85.5	76.0	85.1
Service	68.7	69.4	67.2	64.0	63.8	58.4	60.0	42.2
All other nonfinancial	71.4	72.5	67.5	67.0	58.9	76.0	51.4	70.4

* *Federal Reserve Bulletin*, September, 1959, p. 1117.
† Includes loans for borrowers whose size was not ascertained.
‡ Includes commodity dealers.

These categories are plant and other real estate, assignment of claims, endorsed or co-maker, and equipment—all of which represent classes of security readily available to small concerns. One class, endorsed or co-maker, is available principally to small companies as a practical matter.

Inventories have long been used as security for commercial bank loans. In 1955, they accounted for 9.2 per cent of secured loans and were thus fifth in importance as a class of security. This represented a decline

from 20.6 per cent and first place in importance as security in 1946. The reasons for this marked change in relative importance are not entirely clear. Conjecture suggests that 1946 was in a period of rapid inventory build-up, which can be done quickly in contrast with the time required for increasing plant and equipment. Therefore, inventories offered a more readily available security. Again, it may be that inventory loans have gone to competing nonbanking institutions.

Term Loans. One of the more significant developments in banking practice from the viewpoint of financing corporations is the term loan. A term loan may be defined as a loan having a life longer than one year, with provision for a periodic amortization of the loan during its life. The fact that such loans may be made for as much as ten years or longer and frequently are made for a five-year term indicates that they are used for other purposes than current financing. However, based on a 1957 bank study, approximately 60 per cent of them are made for terms under three years; and this, together with the fact that monthly or other periodic payments are usually the rule, means that the problem is essentially one of financing and managing the current assets. At all events, the loan must be used so as to provide means of repayment in accordance with the payment schedule. Its importance lies in the fact that banks now regularly make loans upon a longer-term basis. The longer term permits the better planning by management which can come with regularized methods of repayment. Term loans are sometimes made by a group of banks, and insurance companies, pension funds, and others may join in particularly for the longer-term notes.[5]

Nearly all (93–95 per cent) of term loans made to small concerns were secured. The security was primarily real estate and equipment. As the size of the borrower increased the proportion of secured loans decreased until it reached 22.5 per cent in the over $100,000,000-asset class. "Equipment" remained an important class of security in loans to large borrowers, but the "assignment of claims" (i.e., receivables, contracts, etc.) replaced real property in importance as a security.

Frequently, the loan agreement requires the borrower to follow prescribed policies or operate within designated limitations. Thus, the borrower may be unable to pledge any otherwise unpledged assets, to arrange additional long-term loans, to raise executive salaries, or to pay dividends without approval of the lender except to the extent such actions do not violate other prescribed standards. Well over 90 per cent of term loans are payable in regular installments. Some may have installments which leave a "balloon" payment on the final date. A few loans call for a single payment on maturity.[6]

Interest charges on term loans may be based on the original amount

[5] Benjamin H. Beckhart, ed., *Business Loans of American Commercial Banks* (New York: The Ronald Press Co., 1959), pp. 231–32.

[6] *Federal Reserve Bulletin*, April, 1959, pp. 353–68.

of the loan throughout the life of the loan or upon the declining balance outstanding. The former method serves to increase substantially the effective rate of interest. (See Table 59.) In the 1957 study, 5.6 per cent of the amount of term loans carried interest on the original amount, but 39.5 per cent of the *number* of term loans fell in this group. A majority of small borrowers were in the group which paid interest on the original amount. This fact does not necessarily infer discrimination against

TABLE 59

AVERAGE INTEREST RATES ON INSTALLMENT AND OTHER MEMBER BANK TERM LOANS CLASSIFIED BY SIZE OF BORROWER, OCTOBER 16, 1957*

Size of Borrower (Total Assets, in Thousands of Dollars)	Average Interest Rate (In Per Cent)	Amount Outstanding: Average Loan (In Thousands of Dollars)	Amount Outstanding: Total (In Millions of Dollars)
	Installment Repayment, with Interest on Original Amount of Loan		
All borrowers†	8.74	4.6	868
Less than 50	9.96	1.9	205
50–250	9.55	4.8	246
250–5,000	8.25	16.9	246
5,000 and over	5.51	162.8	137
	Other Repayment Methods‡		
All borrowers†	4.52	50.2	14,553
Less than 50	5.46	4.7	468
50–250	5.24	14.5	1,700
250–5,000	5.02	71.5	3,570
5,000 and over	4.05	989.2	8,059

* *Federal Reserve Bulletin*. April, 1959, p. 360.
† Includes a small amount of loans to borrowers whose size was not ascertained.
‡ Represents repayments in a lump sum and repayments on installment with interest calculated on outstanding balance.

small business since term loans are relatively expensive to supervise and many of the costs do not vary appreciably with the size of loan.

During World War II and the postwar period stand-by agreements were utilized in connection with term loans. In this method, the corporation arranges with a bank or banks to obtain a loan well in advance of the actual need for funds. All the terms of the loan are established, and the corporation pays a commitment fee pending the time when the funds are actually obtained. Illustrative of the method is the arrangement reported to have been made in July, 1958 by Trailmobile Finance Company (a subsidiary of Pullman, Inc.). A credit agreement was made with a group of sixteen banks headed by Mellon National Bank and Trust Company, Pittsburgh, Pennslyvania, whereby a $75,000,000 credit was made available until August 1, 1962.

The commitment fee was ⅜ per cent per annum (365 days) on the daily average unborrowed amount of the credit during the period ended with the last day of the preceding month for which such commitment fee had not been paid. Provision was made for reduction of the stand-by credit at the option of the company.

The interest rate on loans under the credit agreement was to be calculated at a rate per annum (based on a year of 365 days) which was to be ¼ per cent above the prime commercial loan rate of Mellon in effect at the beginning of each period, with a minimum of 3 per cent, and a maximum of 4½ per cent, until maturity; after maturity, the rate was to rise to 5 per cent. The borrower had the right to renew for a further period ending August 1, 1967; interest was to be ½ per cent above the prime rate, with a minimum of 3¼ per cent and a maximum of 4¾ per cent.

Interest Cost of Bank Financing. The interest rate paid on bank loans is a function of the size of the borrower, the size of the loan, the type of security, and the duration of the loan. The first two factors, size of borrower and size of loan, are closely interrelated and most important in

TABLE 60

AVERAGE INTEREST RATES ON MEMBER BANK BUSINESS LOANS, BY TYPE OF SECURITY AND SIZE OF BORROWER, 1955 AND 1957*

Type of Security	All Borrowers†	Size of Borrower (Total Assets in Thousands of Dollars)						
		Less than $50	$50–$250	$250–$1,000	$1,000–$5,000	$5,000–$25,000	$25,000–$100,000	$100,000 and over
	October 16, 1957							
Unsecured	4.5	6.5	5.7	5.2	4.8	4.5	4.2	4.1
Secured	5.2	6.5	5.7	5.4	5.2	4.8	4.5	4.1
All Loans	4.9	6.5	5.7	5.4	5.1	4.7	4.3	4.1
	October 5, 1955							
Unsecured	3.5	6.0	5.2	4.5	3.8	3.6	3.3	3.1
Secured:								
Endorsed or co-maker‡	4.6	6.0	5.1	4.6	4.1	3.8	3.5	3.4
Assignment of claims§	4.7	5.8	5.6	5.1	4.7	4.4	3.9	3.6
Inventories‖	4.3	5.8	4.8	4.5	4.2	3.8	3.8	3.5
Equipment¶	5.1	7.9	6.6	5.5	5.1	4.2	3.3	2.7
Plant and other real estate	4.7	5.2	4.9	4.7	4.5	4.3	4.3	3.6
U.S. Government securities	3.4	4.3	3.7	3.6	3.1	3.0	3.6	2.4
Other bonds	3.6	4.7	4.0	3.8	3.4	3.6	3.3	3.5
Stocks	4.1	4.8	4.4	4.1	3.9	4.0	3.9	3.7
Life insurance and savings accounts	4.1	4.7	4.2	4.0	3.7	3.8	3.9	3.7
Other security	4.3	6.1	5.0	4.6	4.2	4.1	3.8	4.0
All Secured Loans	4.6	5.9	5.1	4.7	4.4	4.1	3.7	3.1

Source: *Federal Reserve Bulletin*, September, 1959, p. 1121.

* Average annual rate at member banks, in per cent. Average rates computed by weighting each rate by the dollar volume of loans originally made at that rate.

† Includes loans for borrowers whose size was not ascertained.

‡ Includes nongovernment guarantees.

§ Includes assignment of contracts, accounts receivable, and oil runs.

‖ Includes trust receipts, warehouse receipts, and factors liens.

¶ Includes assignment of title and chattel mortgages.

determining interest rates. This is true because the larger the business, the greater its financial stability, which lessens the risk element to the bank. Also, the larger the borrower, the larger the loan and the lower the bank's overhead costs involved in making and servicing the loan. Table 60 summarizes the average interest rates on loans outstanding on the books of member banks in October, 1955 and 1957.

The foregoing observations stand out prominently. Almost without exception the larger businesses borrowed at lower rates than the smaller businesses. With the exception of the two smallest size classes in each year, the unsecured loans carried lower rates than the general average of secured loans. This probably reflects the fact that unsecured loans are made only to borrowers having better or best credit ratings. Moreover, secured loans involve more paper work initially and, in some cases, closer supervision during the life of the loan.

While the interest data given in Table 60 may appear to be only of historical significance, it is believed that the general relationship which they reveal has continued, although interest rates have risen since 1955–57.

TABLE 61

AVERAGE OF RATES CHARGED ON SHORT-TERM LOANS TO BUSINESSES BY BANKS IN SELECTED CITIES, 1941–60*

Year	All Loans	Size of Loan			
		$1,000–$10,000	$10,000–$100,000	$100,000–$200,000	$200,000 and Over
1941	2.0	4.3	3.0	1.9	1.8
1942	2.2	4.4	3.2	2.2	2.0
1943	2.6	4.4	3.4	2.5	2.4
1944	2.4	4.3	3.3	2.6	2.2
1945	2.2	4.3	3.2	2.3	2.0
1946	2.1	4.2	3.1	2.2	1.7
1947	2.1	4.2	3.1	2.5	1.8
1948	2.5	4.4	3.5	2.8	2.2
1949	2.7	4.6	3.7	3.0	2.4
1950	2.7	4.5	3.6	3.0	2.4
1951	3.1	4.7	4.0	3.4	2.9
1952	3.5	4.9	4.2	3.7	3.3
1953	3.7	5.0	4.4	3.9	3.5
1954	3.6	5.0	4.3	3.9	3.4
1955	3.7	5.0	4.4	4.0	3.5
1956	4.2	5.2	4.8	4.4	4.0
1957	4.6	5.5	5.1	4.8	4.5
1958	4.3	5.5	5.0	4.6	4.1
1959	5.0	5.8	5.5	5.2	4.9
1960	5.2	6.0	5.7	5.4	5.0

* *Federal Reserve Bulletins*, July, 1951, p. 842; July, 1953, p. 749; July, 1956, p. 731; January, 1961, p. 59.

This is borne out by reviewing the data contained in Table 61, in which interest rates are classified by size of loan instead of by size of borrower and are carried down to 1960. Also, they are from selected cities rather than being based on a representative sample. However, it seems reasonable to assume that the size of loan and the size of borrower are closely associated and that these data tend to confirm the 1955–57 study.

The longer-term loans carry higher interest rates than short-term loans for all sizes of loans and of borrowers. This is due largely to the fact that longer terms may involve greater risks. The risks may be in terms of increasing chances of nonpayment or in terms of lost opportunities to recommit funds at higher rates. The latter factor always assumes more importance in the determination of loan terms if there are indications that interest rates might turn upward. During the latter part of 1947, there was some evidence of a firming of interest rates. As a protection against this contingency, some banks began to tie the interest rate on term loans to the Federal Reserve bank rediscount rate; and one bank required that its term loans carry a rate 1 per cent above the yield prevailing on Treasury 2's 1954–52.[7] In this way, the banks avoided part of the risk arising from a loss of opportunity to enjoy higher rates at the expense of a known interest cost to the borrower. In exchange, the borrowing company probably enjoyed a lower rate in the present and longer maturities than might otherwise have been obtainable. While there was no way to forecast definitely the long-term trend of interest rates in 1947, they have in fact risen steadily if slowly since that time, as is shown in Table 61.

Bankers' Acceptances. Another method for obtaining low-cost current financing within the framework of the banking system is through the use of bankers' acceptances. A banker's acceptance is a draft drawn by the seller upon the bank of the buyer (instead of upon the buyer himself, as is true of trade acceptances). The seller does this under instructions of the buyer, who has, in turn, arranged with his banker to accept the draft upon its presentation. Usually, the bill of lading and other papers are attached to the draft when sent to the bank. It "accepts" the draft and returns it to the seller, retaining the papers for whatever disposition has been agreed upon with the buyer. The accepted draft becomes a high-quality negotiable paper because it is an obligation of a bank and a contingent obligation of the drawer (seller) and because it is an instrument arising out of an actual and, presumably, self-liquidating transaction. As a result, the original seller of merchandise can discount the banker's acceptance at an extremely low rate and then obtain immediate payment for the goods sold. In March, 1961, prime bankers' acceptances, ninety-day maturity, sold for an average rate of 2.94 per cent. In the same month, the average rate on commercial loans in nineteen cities was 4.97 per cent.[8]

---

[7] *Finance*, November 15, 1947, p. 45.

[8] *Federal Reserve Bulletin*, April, 1961, pp. 439–40.

Such paper receives most of its use in connection with foreign trade and is, accordingly, of rather limited use to corporations generally. On February 28, 1961, there was $2,049,000,000 in bankers' acceptances outstanding. Of this amount, all but $291,000,000 arose out of foreign trade or foreign exchange transactions.[9]

COMMERCIAL-PAPER HOUSES

When bank facilities are inadequate or it is thought more economical to finance on the open market, the corporation may resort to the use of the commercial-paper house. The commercial-paper house is in reality a middleman specializing in the purchase and sale of promissory notes or reputable corporations and businesses. It buys the promissory notes, usually in the form of a series of notes in round amounts such as $1,000 or $2,500, and resells them to banks or other investors who have idle funds and wish to make temporary investments. The commercial-paper house buys the notes only after the most careful investigation. Although the notes are not endorsed, the fact that they are offered by a recognized institution is an index of quality and results in ready salability.

This method of financing offers favorable interest rates and also serves to advertise the existence of the borrowing concern through the often widespread ownership of its notes. On the other hand, there is the disadvantage that the borrowing relationship is strictly impersonal; the notes must be paid at maturity, whereas a bank would be more likely to have an element of friendly interest and a willingness to extend the note if circumstances justified. Due to the unwillingness of the holders of commercial paper to renew the loans in times of extreme need, as well as the low interest rates prevailing for bank loans for many years, commercial houses have not been used extensively for some years. Another factor of importance has been the practice of large finance companies to place their own paper directly with private investors. With the reversal of trends in interest rates and the increasing demand for funds, there has been a greater use of dealers' services. At the end of 1954, paper outstanding which had been placed through dealers aggregated $733,000,000; paper directly placed totaled $1,191,000,000. By February, 1961, the respective totals were $1,418,000,000 and $3,489,000,000.[10]

FINANCE COMPANIES

Finance companies are variously classified as discount, accounts receivable, commercial credit, installment finance, and automobile finance companies. The title used may indicate the specialized nature of the particular

---

[9] *Ibid.*, p. 442.
[10] *Ibid.*, p. 442.

firm's operations; or it may be selected entirely in an effort to acquire a noncompetitive corporate title, that is, one that has some distinctive feature and does not infringe upon some existing company's name.

All finance companies, regardless of name, will engage in financing the credit sales of other concerns or in providing funds for some other relatively short-term purpose. Where the borrowing corporation is financing its own credit sales, the usual arrangement is by means of discounting accounts receivable with the finance company or by the outright sale of customers' installment contracts. The first method is applicable to any type of business regardless of its unit sale or the duration of its credit terms.

The second method is used entirely for the types of business involving the sale of relatively durable or expensive equipment which would otherwise call for considerable cash outlay on the part of the buyer. Such items as automobiles, radios, and refrigerators may be financed in this way from the manufacturer through the wholesaler and retailer to the consumer. Heavy, specialized machinery may also be financed by installment contracts which are sold to a finance company.

Corporations that are inadequately financed may establish a continuing arrangement with a finance company wherein all accounts receivable will be assigned to the finance company in exchange for a cash payment equal to the face amount of the accounts less an agreed discount. This discount will ordinarily cover both the financing charge and an additional amount to protect the finance company against the risk that some accounts may not be collected. The amount withheld for the protection of the company may be small and, in some cases, may be nonexistent. However, the usual practice is for the assignment to be made with full recourse, so that the selling or borrowing firm must absorb any credit losses either directly through the reserve withheld by the finance company or indirectly through the substitution of additional accounts. A finance company may also be used to obtain funds for temporary purposes through the assignment of accounts receivable. The discount rate will be higher in such a case because of the extra cost of a special investigation and the absence of the understanding that usually goes with a continuing relationship. In either case, the assignment may be made on either a notification or a nonnotification basis.

Under the notification basis, the selling company notifies its debtors that it has assigned their accounts to the finance company and that the payment is to be made directly to the latter. This method is not popular, as many debtors prefer to keep the transaction directly with the original vendor corporation; and in some lines of activity, borrowing from a finance company upon receivables is sometimes regarded as an indication of a weakened current financial position. As a result, a firm employing this method may lose some of its business if its customers are notified of the fact. The nonnotification basis avoids this difficulty. The firm's cus-

tomers are not notified of the assignment of their accounts; and the selling corporation collects the accounts receivable as they mature, paying the funds directly to the finance company. The fact that the accounts have been assigned for financing purposes need never become an item of general information. While the cost of this type of financing may be rather high, and possibly even higher than similar financing when available from banks, it does, nevertheless, represent an additional source where working funds can be obtained. The amount of funds obtained from this source may be entirely adequate; and the interest rate, though relatively high, may be low in comparison with the profits the borrowing firm is able to make on the added capital. Moreover, the nominal rate charged by finance companies may exceed the actual rate substantially. Such advances are usually on a day-to-day basis, with interest computed accordingly. Bank loans cannot usually be obtained on this basis, and banks also require the maintenance of compensating balances.

Although the assignment of accounts receivable is unpopular and frequently regarded as an indication of weakened current financial condition, no such attitude applies to customers' installment contracts. Corporations that manufacture and sell expensive items, such as automobiles and certain forms of industrial equipment, find it necessary to sell much of their output on relatively long credit terms. If a manufacturing company had to finance all of its customers, it would require large, additional amounts of funds. If the terms of sale were only a year, payable in equal monthly installments, the company would require approximately six times its average monthly sales to finance its installment contracts. This additional financing may be and usually is avoided through the immediate sale of the installment contracts to one of the specialized finance companies. Under these contracts, the purchaser of the merchandise pays directly or indirectly most of the financing cost. Although the interest rate is relatively high, the selling companies prefer to concentrate their operations on manufacturing and sales rather than on financing.

Finance companies specialize in the purchase of receivables or installment contracts, but they also engage in other forms of working capital financing. They make loans upon merchandise inventories secured by warehouse or trust receipts and will advance funds for the purchase of machinery with the amount secured by a lien upon the machinery itself. The broadening of the field of activities of the larger finance companies has introduced both an additional source from which other corporations may finance their working needs and an element of competition in the business of providing funds which should further the development of new financing arrangements and lower the interest cost to borrowers.

The finance companies obtain their own funds through the sale of stocks and bonds and through borrowing from commercial banks on notes secured by the installment contracts they have purchased from other concerns, and as we have seen by the direct placement of their own

commercial paper. This means that the finance companies are, in effect, both a good customer and an active competitor of the commercial banks.

In recent years, the finance companies have developed a new means of financing their operations which makes them less dependent upon the banks for funds and also suggests an additional means of financing which eventually might be used by other corporations. This device is known as the "subordinated note." The subordinated note is simply a long-term or serial promissory note which is subordinate to all other indebtedness of the finance company, including present and future commercial bank loans. Existing issues of such notes have been sold to the larger insurance companies at rates of interest only a little above the rate prevailing on bank loans. The subordinate note usually carries an agreement as to the type of business operations of the borrower and establishes certain restrictions as to the relationships that may prevail between loans having a higher risk and those regarded as carrying the least risk. Frequently, dividends are restricted unless certain working capital or tangible asset relationships are maintained; and stock equity must exceed debt by certain margins.

FACTORS

Factoring companies are similar to finance companies in that accounts receivable provide the usual basis for the lending operation. They differ from finance companies in that ordinarily the factor buys the accounts receivable outright from the selling or borrowing corporation and assumes any credit loss which may be experienced. The arrangement is frequently based upon a continuing contract and may include special services such as are usually rendered by manufacturers' agents. Also, because of the fact that all credit loss is assumed, factors may reserve the right to pass on credit before the sales are made. This has the disadvantage to the borrowing business of using a credit manager, who is interested in a zero credit-loss ratio rather than in credit losses which permit the company to realize the maximum net profit. In opposition to this disadvantage is the advantage that the cost of the credit department is transferred to the factor, and the manufacturer is enabled to concentrate on his operating problems.

Factoring grew up originally in the textile business and is best understood in the various levels found operating within that complicated industry. However, factoring is found in other lines of business, manufacturing, and wholesaling, operating in the larger financial centers of the country, principally in New York and Chicago, although it also exists in some of the smaller eastern manufacturing cities. Factors usually charge from 0.75 per cent to 2 per cent of the face amount of all receivables purchased; lower charges may be found, however, and the amount may rise to as much as 4 per cent if complete credit department services are rendered. In addition, an interest charge on the amount of the advance

may be made. Although factoring has the disadvantage of a rather high financing cost and the imposition of restrictions upon the selling policies of the firm, it may be the only avenue available for providing working funds for new or underfinanced businesses. Factoring companies will advance funds under conditions that other financing agencies are unable or unwilling to assume. Through the regular advance of cash on receivables, coupled with close supervision and management advice from the factors, a new business may be able to improve its situation and gradually build up reserves out of earnings so that it eventually reaches the point where it is able to conduct its operations with funds obtained from more orthodox and less costly sources than are represented by factoring companies.

QUESTIONS AND PROBLEMS

1. Discuss the importance of accounts payable as a source of working capital. Does the turnover of accounts payable cause them to become, in effect, a form of permanent capital?
2. Show how trade terms covering the purchase of materials and their later sale affect the working capital problem.
3. Commercial banks are more important in serving the needs of small companies rather than large companies. Discuss. Is this true in the aggregate?
4. Determine the legal lending limits of the banks in your community. Are these limits adequate to handle the current requirements of the largest concerns in your area?
5. How do interest rates on bank borrowings compare with the rates paid on funded obligations having similar security? Explain.
6. How would you account for the relatively large number of bank loans secured by endorsement or co-makers?
7. Investigate the cost of financing a loan of $15,000 secured by a field warehousing agreement. Do the same for a $50,000 loan.
8. What sizes and types of businesses use accounts receivable as security for working capital loans? Why?
9. Some finance companies will advance 80 per cent of the face value of accounts receivable for 2 per cent discount. If the trade terms are 30 days, what is the effective rate of interest? What profit rate is necessary to justify this type of financing?
10. Discuss factoring as a financing device (see Herbert R. Silverman, "Factoring as a Financing Device," *Harvard Business Review*, September, 1949).
11. Comment on the desirability of governmental agencies making loans to small business.
12. Review the lending policies of the Small Business Administration with special attention to the nominal purpose of the loans made.

REFERENCES

Burchett, Floyd, F., and Hicks, Clifford M. *Corporation Finance*, chap. xxviii. 3d ed. Lincoln, Nebraska: Johnsen Publishing Co., 1959.

Doris, Lillian (ed.). *Corporate Treasurer's and Controller's Handbook*, chap. x. New York: Prentice-Hall, Inc., 1951.

Eckert, James B. "Business Loans of Member Banks," *Federal Reserve Bulletin*, April, 1956, pp. 327–40.

———. "Member Bank Lending to Small Business, 1955–57," *Federal Reserve Bulletin*, April, 1958, pp. 393–411.

Gerstenberg, Charles W. *Financial Organization and Management*, chap. xvi. 4th rev. ed. Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1959.

Greenfeld, Harvey and Grisinger, Frank K. *Sale—Leasebacks and Leasing in Real Estate and Equipment Transactions*. New York: McGraw-Hill Co., 1958.

Holthausen, Duncan McC. "Term Lending to Business by Commercial Banks in 1946," *Federal Reserve Bulletin*, May, 1947, pp. 499–517.

Howard, Bion H., and Upton, Miller. *Introduction to Business Finance*, chaps. xiii–xv. New York: McGraw-Hill Book Co., Inc., 1953.

Jacoby, Neil H., and Saulnier, Raymond J. *Financing Inventory on Field Warehouse Receipts*. New York: National Bureau of Economic Research, Inc., 1944.

———. *Term Lending to Business*, New York: National Bureau of Economic Research, Inc., 1942.

Koch, Albert R. "Business Loans of Member Banks," *Federal Reserve Bulletin*, March, 1947, pp. 253–63.

Osborne, Richards C. *Corporation Finance*, chap. xvii. New York: Harper & Brothers, 1959.

Smith, Tynan. "Security Pledged on Member Bank Loans to Business," *Federal Reserve Bulletin*, June, 1947, pp. 664–80.

Youngdahl, Richard. "The Structure of Interest Rates on Business Loans at Member Banks," *Federal Reserve Bulletin*, July, 1947, pp. 803–19.

Zinner, Shandor M. "The Contribution of Commercial Receivables Companies and Factors to Financing Small and Medium Size Business," *Journal of Finance*, April, 1947, pp. 76–90.

PART VI ►

Corporate Expansion

Chapter 28 ►

EXPANSION, COMBINATION, AND MERGER

THE YEARS since the close of World War II have been years of unprecedented business growth. The pressures of deferred demand accumulated during the war plus a rapidly increasing population created unusual market opportunities crying for satisfaction. To these influences must be added new products based on a new technology and new raw materials. In addition, rising prices maintained a constant pressure in terms of both profit opportunity and financial need. Under the circumstances it is not surprising that corporations expanded operations both through the construction of additional capacity and by the acquisition of existing facilities by direct purchase or merger. The extent of the expansion through acquisition or merger led many students to a fear of monopoly or an undesirable restriction of competition. With the criticism of the rate of growth (or success) of some corporations there was often a failure to appreciate the underlying causes.

It is the universal desire of mankind to grow, because growth in some form is essential to existence. Advancement may be either intensive or extensive in character, which means that it may assume the form of internal improvement or of external enlargement. In the case of the individual, the former may be cultural growth in the broadening of personality and understanding. In the case of an institution, such as a business, growth may take the form of improving techniques and products or of facilitating relationships such as exist in connection with labor control and wage systems. Business firms may experience a sufficient amount of qualitative improvement to maintain their vitality without increasing their size, but the most common form of growth takes the form of expansion or enlargement of operations in the physical and financial sense. In this chapter the chief concern is with the quantitative phases of expansion as they relate to financial problems.

Why should a business corporation desire to grow? Why should it not be satisfied with an established place in the business world and be content

with fair profits? As related previously, the reasons are deep-rooted and reflect an innate characteristic of progressive civilization. Moreover, the internal urge of individual business leaders is stimulated by various forces of a psychological and an economic nature. Among these, the following may be mentioned:

1. Competition encourages growth. Unless a business firm expands, it will frequently be surpassed by competing groups. Indeed, it may have no choice but to expand. Business is essentially dynamic, and to stand still actually means a loss of position. The concern that is unable to make progress at a rate comparable with that of the entire industry develops a deadening inertia which frequently leads to decline and failure. Conversely, the momentum developed by sound expansion is a source of vitality and vigor.

2. The possibility of greater profits is equally stimulating. Although net earnings may be increased by operating more efficiently on the existing scale, the opportunities are more limited than when there is an expansion of the field of activity. In addition, large-scale operations may permit economies and advantages not obtainable to the same degree on a smaller scale.

3. Business enterprisers like to do the spectacular, either for the sake of personal satisfaction or for social recognition. To them, business is a game; and maintenance of operations on a large scale offers satisfaction as well as possible profit.

4. Finally, monopolistic ambitions may be the cause of expansion. There are autocrats or dictators in business as well as in the realm of politics, and they are not satisfied with anything less than control of the field in which they are operating.

METHODS OF EXPANDING OPERATIONS

The usual way for a corporation to expand its operations is through a process of natural growth financed out of earnings or new security flotations. As discussed in earlier chapters, small corporations have little alternative but to finance expansion through retained earnings. Larger concerns have the added source of funds obtainable from the organized securities markets. Growth from within, coupled with that financed by periodic security issues, has the advantage of being of a progressive or evolutionary character. This should afford an opportunity to keep financial errors at a minimum, but the method has the difficulty of being a slow process. In a few cases, the growth may be phenomenal, e.g., that of the Ford Motor Company; but, for most companies, it is a slow and uncertain method. Such companies are usually closely held and are not required to publish annual reports; as a consequence, adequate or typical illustrations of this process are difficult to obtain. By the time their growth is sufficient to indicate substantial success, some form of combination, typically merger, has been used. This is almost inevitable since, sooner or

later, the time will come when competitors will limit further growth unless they can be absorbed or eliminated as competitors through some form of joint action.

To the desire for speed and for reduction of competition should be added the fact that it may be possible to acquire existing corporations more cheaply than to establish equivalent operations. When such factors as these are considered, it is not surprising that corporate growth frequently finds its expression in some form of corporate combination.

METHODS OF EFFECTING COMBINATIONS

Corporate combinations may be effected in a number of ways that reflect the purpose of the combination and the laws applying to combinations and restraint of trade. When the purpose is primarily one of controlling markets and competition, an informal arrangement may be expected. On the other hand, when the purpose is primarily one of achieving the economies that may be inherent in a larger-scale, integrated operation, a formal legal organization will be used.

In the broadest application of the term "combination," we may include all the devices by which corporations attain a unity of direction and expansion of operations or control. These may range all the way from gentlemen's agreements to outright amalgamation of the separate units into a single corporation. On occasion, there appears to be some tendency to exclude mergers and give them separate treatment. For purposes of discussion here, the various methods of combination have been classified as (1) informal methods; (2) formal methods with separate identities; and (3) outright absorption of separate corporations, or merger.

INFORMAL METHODS OF COMBINATION

Informal methods are used when the purpose is to restrict competition or when it is desired to obtain an element of co-operative action without formal organization. This may be to avoid the financing and other problems involved in formal arrangements; it may be due to a temporary purpose. Since these methods are informal and usually illegal, there is no factual information on the extent of their use.

Gentlemen's Agreement. One of the first methods of general application consisted of an ordinary gentlemen's understanding in which the interested parties merely agreed orally not to cut prices or promised to restrict activity in keeping with the terms of the agreement. This arrangement, however, had neither legal sanction nor administrative organization for purposes of enforcement. As a result, the participants were prone to violate the agreements whenever it was to their profit to do so.

Pools. In order to secure a more definite and comprehensive program on the part of the participating concerns, the pool was developed. There was ordinarily a written agreement providing for a co-operation of effort

in exploiting the available markets. There were many kinds of pools—for example, pools for the common distribution of profits; pools in which the production was assigned on a predetermined equitable basis; pools in which all the members sold their output to a common agency for resale to the markets; and patent pools, in which the members mutually used all patents.

The pool was formally organized and usually had a central administrative agency to which all the members reported. In the event that any of the members violated their agreement, a penalty was imposed and collected by the central office. Such supervision served to make the pool slightly more effective than the gentlemen's agreement; but, at the same time, no legal means of enforcement were available because the agreements were illegally in restraint of trade. As a result, individual members were likely to desert whenever they had an opportunity to make unusual profits. A number of such recurrences would usually cause the complete dissolution of the group. Moreover, the various pools rarely included all the productive capacity and usually found it difficult to control the market influence of small companies not included.

It is probable that the basic weakness of pools stemmed from a desire to overdo the degree of exploitation. If they had been content with modest increases in price above normal competitive levels, they might have been more durable. This was not the usual case; and the high prices and high profits soon brought desertions, new competitors, or enlargement of the nonparticipants.

Community of Interest. An informal, although often effective, method of achieving some of the benefits of combination is through a community of interest. A community of interest occurs whenever a small group of persons—members of a family or close acquaintances—owns the controlling interest in several corporations. The owning group is then able to manage the separate companies with a single common objective, without any general public knowledge of the arrangement.

Two disadvantages appear for this method of co-ordinating business policy. From the viewpoint of the corporations, it is a loose organization depending upon personal relationships rather than legal obligations for its effectiveness. In this respect, it is similar to the earlier gentlemen's agreements. From the social viewpoint, the community of interest may represent a nonlegal method of accomplishing an illegal combination for some purpose such as the restriction of competition.

Interlocking Directorates. A more tangible method of securing common action among corporations without actual merger is through the use of interlocking directorates. Whenever the boards of directors of two or more corporations have members common to each board, an interlocking directorate exists. Although these "common" members may never carry confidential information between the various boards, they are able to influence the corporations' policies toward united or co-operative action.

Unlike the community of interest, interlocking directorates cannot be concealed and, as a result, can be regulated by law. The Clayton Act prohibits interlocking directorates in large national banks (deposits and net worth of more than $5,000,000) or in industrial corporations of over $1,000,000 net worth which have been or are competitors of each other. Similarly, the Banking Act of 1933, separating investment and commercial banking, prohibits common directors between Federal Reserve member banks and investment banks. On the permissive side, railroads may have interlocking directors only with the approval of the Interstate Commerce Commission; registered public-utility holding companies may have common directors with banks subject to the rules of the Securities and Exchange Commission.

FORMAL COMBINATIONS WITH SEPARATE IDENTITIES

Trusts. Properly speaking, the term "trust" refers to a form of legal relationship (or fiduciary arrangement) and does not necessarily mean the existence of a monopoly or the presence of a combination of companies. However, some of the largest combinations to be organized, and those that held the position of attention at the close of the last century, adopted the trust form of organization. As a result, it is not uncommon to find monopolies or quasi monopolies referred to as "trusts."

Under the trust form, the stockholders of the constituent concerns turn in their stock to a board of trustees and receive in exchange trust certificates evidencing the receipt of shares. These trust certificates can then be bought and sold just like the original stock certificates. They have all the rights, privileges, and values of stock certificates except voting power. The board of trustees has complete control inasmuch as it holds all the stock, or at least a working majority of the stock of the constituent companies, with its voting power. This gives formal, legal control to the central organization and offers none of the loopholes in the pool plan.

The method was used effectively to organize a number of large and powerful groups which exercised substantial control over their markets; but its effectiveness was soon limited by the Sherman Antitrust Act of 1890, which declared combinations in restraint of trade to be illegal. Following this act, it became necessary to devise some plan which embodied practically the same features in so far as control was concerned but, at the same time, a plan that would be legal. This was the objective of the holding company, which was the next step in the evolution of forms of combination.

Holding Companies. The essential difference between the trust plan and the holding company is the directness of control. Under the former, a board of trustees has the express and exclusive right to vote the stock held in trust and is able to run the member businesses without restriction or influence by the stockholders. This board of trustees has the relationship to the stockholders which usually prevails between a trustee and his

principal. On the other hand, the holding company is a separate corporate structure which has the same rights; but the control of the holding company itself needs to be guarded. Practically, the holding company retains all the effectiveness of the trust plan and, at the same time, occupies a better legal position.

The legality of the holding company was first tested in the Northern Securities Case of 1904, involving a company that had been organized for the specific purpose of acquiring the stocks of two competing railroads, the Great Northern Railway Company and the Northern Pacific Railway Company. The courts held that this was action in restraint of trade and, hence, contrary to the Sherman Antitrust Act of 1890. The case raised doubt as to the legal status of the holding company but did not eliminate the device as a means of effecting combinations. Admittedly, holding companies may cause restraint of trade to a greater or lesser degree; but the attitude of the courts has been modified to insist only that the restraint shall not be unreasonable.

The holding company is subject not only to possible legal attack, but it may at times become cumbersome and uneconomical in its organization. Hundreds of subsidiaries may be acquired, and holding companies are sometimes formed for the purpose of holding the stock of other holding companies. Even in the comparatively simple holding company organizations, the method results in the duplication of overhead expenses in the form of corporate franchise taxes and other items. To avoid these various difficulties, the companies affected may be completely absorbed into a single organization. (See following chapter.)

Leases. Under the lease arrangement, a rental agreement is effected whereby the operating company pays a rent as a consideration for the right to use the physical properties of the owning company or companies. The leases are frequently arranged for long terms and are usually renewable. This plan is used widely in the railroad field because the owning corporation retains its legal identity. As a result, it is not necessary to carry out any new financing, as would be the case in an outright consolidation or merger. Moreover, many small railroads have favorable charters which could not be transferred to any successor corporation. An outstanding example of the use of the lease method is the New York Central Railroad. As of December 31, 1959, this company operated 21,524 miles of track, of which 9,738 miles, or 45 per cent, was on a lease or contract basis.

OUTRIGHT ABSORPTION OF SEPARATE CORPORATIONS

The molding of separate companies into a common and single organization may be accomplished either by the enlargement of an existing concern or by the creation of a new corporation. Under the first plan, one

existing company expands its capitalization, obtains the outstanding securities of the other companies by giving its own in exchange, and then usually arranges for the dissolution of the corporate identities of the merged companies. Under the second arrangement, a *new* corporation is organized to take over all the individual concerns involved, after which the process of exchanging securities and the dissolution of the separate corporate entities are about the same as in the other procedure. Technically, the first method is known as a "merger" and the second as a "consolidation." It can be seen that either method has the same results and avoids the burden of carrying additional organizational units. For this reason, the terms are frequently used interchangeably, with the most prevalent practice being to refer to all combinations which result in a single corporation as "mergers." In the subsequent discussion, the word "merger" will be used to cover both methods; and "consolidation" will be referred to as such only when some legal distinction may be necessary.

The merging of other companies into an existing organization is well illustrated by the General Motors Corporation. Many of the companies bought have been absorbed by General Motors Corporation and do not retain their original entities. As a result, General Motors is primarily an operating concern owning the plants, properties, and other assets involved in its manufacturing operations. Operations are carried on by the Chevrolet Motor Division, Buick Motor Division, and other divisions producing cars or other manufactured products; but the divisions have no separate legal existence apart from the General Motors Corporation. In addition, the General Motors Corporation is a holding company having stock interests in the General Motors Acceptance Corporation, the General Exchange Insurance Corporation, the Yellow Manufacturing Acceptance Corporation, the Euclid Road Machinery Co., and certain foreign subsidiaries.

HISTORICAL BACKGROUND

There is a real and exciting history behind the majority of industrial combinations. They may start in a small, inconspicuous way, then burst forth almost overnight and appear as extensive new organizations in the business world. The next chapter may find them curbed or broken up by the courts. Under the principles of common law, restraint of trade is recognized to be an illegal act. Similarly, it has been the intent of numerous statutory enactments to restrict corporate combination, at least to the extent of preserving a degree of competition. However, there is a large element of uncertainty concerning the interpretation of restraint of trade and the conditions under which legal action may be taken by public authority. Consequently, legal restrictions have not greatly inhibited the promotion of various types of corporate "get-togethers." Some more or

less effective method is always found which conveniently fits the law, and just as frequently it is changed as the law catches up with existing practice.

While many mergers of independent companies are initiated to effect economies in manufacturing and distribution, there are others that are undertaken primarily for purposes of control. The latter serve to restrict freedom of competition, which is so essential to the normal working of that important governor of business activity—price. As a consequence, markets may not reflect basic trends at any particular moment of time; instead, bias and restraint appear because of the control imposed by a few organizations. This is not the place to discuss the merits of free and open competition as compared with various degrees of control; but, as stated previously, combination does affect the public interest. In this country, there appear to have been four periods of active development, separated by intervals of relative inactivity. The periods of development date approximately as follows: (1) 1885–93, (2) 1897–1903, (3) 1919–29, and (4) 1940 to date.

First Period of Development, 1885–93. The problem of industrial combinations took form with the organization of the Standard Oil Trust in 1885. Minor mergers had occurred before this time, but they were not sufficiently outstanding to attract public attention. Two years later, the American Sugar Refining Company was organized by combining a number of existing concerns; and this, along with the oil trust, tended to make the problem a public question and a political issue. Popular reaction was such that the Congress enacted the now well-known Sherman Antitrust Act of 1890. Despite this legislation, other trusts were organized—for example, the National Lead Company in 1890 and the General Electric Company and the United States Rubber Company in 1892. Many combinations organized at this time are still operating today, although in somewhat modified form. Whether this is purely coincidence or the result of economic and other advantages acquired through combination cannot be stated with accuracy. Probably various factors consisting of the type of product, skill of management, efficiency of operation, and influence on market outlet account for this outstanding record of performance.

The vigorous expression of general opinion at that time is a significant commentary on the interest of the public in business affairs. The combinations then occurring are dwarfed in comparison with those of the present day, but the ideal of free enterprise was sufficient to serve as a call to arms. Many developments, of both a political and an economic nature, have occurred since that time to weaken our zeal for the freedom of the business seas; and there is a tendency to substitute security for the rigors of individual action. This changing philosophy must inevitably affect the character of our business system. Indeed, it is possible that large-scale operation may become the accepted mode of business conduct. In this event,

however, it may be expected that the government, as the spokesman of public interest, will change its traditional role from that of umpire to active participant.

Second Period of Development, 1897–1903. In the second period, many combinations were formed simply because they were the vogue. The "combine" came to be accepted as a panacea for business ills; and, with such indiscriminate use, many of the new organizations did not survive. However, it may be said that the real combination movement began at this time. It has been estimated that, in the year 1899 alone, there were some 259 industrial combinations formed, each having a capitalization in excess of $1,000,000.[1] In the three years from 1898 to 1900, there were organized 149 combinations with a capitalization totaling $3,128,650,000.[2] Such prominent companies as the United States Steel Corporation and the International Harvester Company date from this period.

Third Period of Development, 1919–29. The nineteen-twenties heralded a new day in the development of big business. The theme of expansion was common with that at the turn of the century, but the scale and pace were more phenomenal. Unfortunately, giant enterprises were created too often more by the spur of quick profits from promotion than they were evolved from promising business opportunity. And the period of reckoning took the form of the most severe and prolonged depression our country has ever known.

During the period 1919–29, there were 7,256 mergers or acquisitions[3] of sufficient importance to be reported by the leading investors' services. These were not concentrated in any one industry but were distributed throughout the various fields of industrial activity.

While the data in Table 62 give only mergers in the fields of manufacturing and mining, it must not be inferred that combinations were characteristic of those fields alone. The 1920's were also years of striking development in public-utility integration. They were also years of financial excesses and malpractices which later led to regulation and to the development of a public power program by the federal government. A measure of the extent of the combination movement in the utility field is given by the fact that 4,329 companies disappeared in the ten-year period 1919–28 as a result of mergers.

---

[1] *Commercial and Financial Chronicle,* Vol. LXX, p. 561.

[2] E. S. Mead, *Trust Finance* (New York: Appleton-Century-Crofts, Inc., 1933), p. 2.

[3] The compiler of these data, the Federal Trade Commission, defines the term "acquisition" to include "all business and corporate organizational and operational devices and arrangements by which the ownership and the management of independently operated properties and businesses are brought under the control of a single management." (*Report on Corporate Mergers and Acquisitions,* 1955, p. 8.) Obviously, this term is broader than mergers, but in practice it appears to include mergers and consolidation—the usual meaning plus comparatively few cases of acquisition of operating units, such as plants or divisions, without acquiring the corporate identity of the previous owner.

Big names and precedent have their effect in business just as they do in other segments of human activity. It is not surprising, therefore, that many combinations occurred purely for their own sake in response to the momentum of the movement and because of their sponsorship by well-known financial interests. Combination became the accepted goal, and promoters were seeking more actively than usual for such opportunities as a source of profits. Undoubtedly, the stimulus for combination arose more often from financial sources outside the companies involved than from managerial influence within. As a result, many combinations were

TABLE 62

NUMBER OF MERGERS AND ACQUISITIONS IN MANUFACTURING AND MINING BY YEARS AND CUMULATIVE, 1919–60

Year	Annual Total	Cumulative	Year	Annual Total	Cumulative
1919	438		1940	140	9,660
1920	760	1,198	1941	111	9,771
1921	487	1,685	1942	118	9,889
1922	309	1,994	1943	213	10,102
1923	311	2,305	1944	324	10,426
1924	368	2,673	1945	333	10,759
1925	554	3,227	1946	419	11,178
1926	856	4,083	1947	404	11,582
1927	870	4,953	1948	223	11,805
1928	1,058	6,011	1949	126	11,931
1929	1,245	7,256	1950	219	12,150
1930	799	8,055	1951	235	12,385
1931	464	8,519	1952	288	12,673
1932	203	8,772	1953	295	12,968
1933	120	8,842	1954	387	13,355
1934	101	8,943	1955	689	14,044
1935	130	9,073	1956	638	14,682
1936	126	9,199	1957	598	15,280
1937	124	9,323	1958	543	15,823
1938	110	9,433	1959	719	16,542
1939	87	9,520	1960	700	17,242

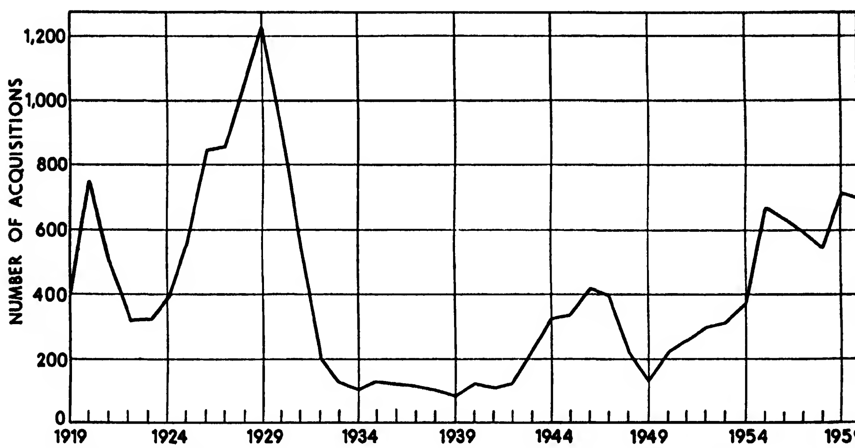
Source: Federal Trade Commission, *Report on Corporate Mergers and Acquisitions* (Washington, D.C.: U.S. Government Printing Office, May, 1955), p. 33. 1955–60 data by informal discussion with F.T.C.

effected primarily for purposes of financial strategy and manipulation and to provide a supply of new security issues to be sold to unwitting investors. Internal operating efficiency, as measured by costs per unit, was too frequently ignored. The basic merits of merger were also overlooked, and greater emphasis was placed upon the development of organizational forms for purposes of control than for the actual production of goods.

Fourth Period of Development, 1940 to Date. After reaching a high in 1929, the rate at which corporate mergers took place declined sharply and remained low throughout the depression period. Profit opportunities did not encourage combinations, and government attitude was not

friendly to such activities. Beginning in 1940, there was evidence of an increase in mergers. This increase became more pronounced in 1942, with a definitely rising trend through 1946. The number then declined to the level prevailing in the late 1930's to a low point in 1949 after which the number of mergers increased again through 1960, the last year for which data are available. Figure 1 shows the data contained in Table 62.

FIG. 1. Number of Mergers and Acquisitions in Manufacturing and Mining, 1919–60 (Annual Totals)



Source: See Table 62.

In the 1940–54 period, more than 3,600 mergers and acquisitions occurred, or about 240 per year (see Table 62). While this number does not appear large in relation to the 130,000 corporations operating in manufacturing and mining at that time, it must be remembered that only the larger and more important cases are included in the series. Moreover, the reported mergers were concentrated in a few industrial lines. In the 1956–60 period, the number of mergers increased to an annual average of about 650.

The largest number of disappearances during 1940–54 were in the manufacturing groups classified as food and kindred products, nonelectrical machinery, and chemicals including drugs. These three groups accounted for 37 per cent of the reported mergers.[4] The merged firms were relatively small, while the acquiring firms were comparatively large; 30 per cent of the acquiring companies had in excess of $50,000,000 in assets, 32 per cent had between $5,000,000 and $49,000,000, while only 10 per cent had assets under $1,000,000.[5]

It will be observed from Figure 1 that mergers are a phenomenon re-

[4] Federal Trade Commission, *Report on Corporate Mergers and Acquisitions* (Washington, D.C.: U.S. Government Printing Office, 1955), p. 35.

[5] *Ibid.*, p. 34.

lated closely to the level of economic activity. The peak was reached in the boom year, 1929; and the low was reached during the depression period. The increases since 1942 have not gone to the heights of 1929, but they have been related to the economic opportunities of an expanding economy and to current business prospects. The reasons underlying individual mergers are highly varied and often complex.

The acquiring, and usually the larger, company may be motivated by a desire to control its market or source of supply more adequately. It may need to expand to meet the demand for its product, and buying another company may be the quickest and cheapest way. Or it may simply be looking for a way to use excess funds. The merged company may have entirely different and often noneconomic reasons. It may have been willing to sell out because of an inability to cope with competition or, contrariwise, because it received an exceptionally good offer. But usually, the merged company is comparatively small and subject to a variety of personal factors.

TAXATION AND THE RECENT MERGER MOVEMENT

The typical small company is owned and controlled by a few important stockholders (often only one) who constitute the active management. Owner-managers are willing to sell because of a desire to retire, because of ill-health, or for tax reasons.

The tax laws are often offered by owner-managers as reasons for selling, or wanting to sell, their businesses to other concerns. Depending upon individual circumstance, the tax motive may express itself in a desire to minimize estate taxes or to draw off accumulated earnings so as to take advantage of the capital-gains provisions in the tax law.

Many businessmen believe that government officials are inclined to overvalue unlisted and untraded stock held in estates. Where stock is traded actively, a market value is established; and this value can be applied to stock held in a decedent's estate. The stock of the usual small company may be closely held by one or a few persons. No sales of stock may have been made except on a private-sale, unrecorded basis. Lacking a fair market value, officials of the Internal Revenue Service must establish such a value through recourse to earnings data and book values. In doing this, the proper rate for capitalizing earnings and the effect of the death of the principal owner upon the business' prospects become important and debatable matters, along with many other considerations. Even if such questions did not exist, there would still be the problem of having sufficient cash in the estate to pay taxes without any element of forced liquidation. By selling out to a larger company with more actively traded stock, the owner-manager can arrange a tax-free exchange and obtain a more readily marketable stock at the same time. Or he can take cash, recognize capital gains, and achieve a liquid position prior to death.

While there may be considerable question as to the proper importance to give the tax factor in any specific case, it has been shown to be of considerable weight in some cases. Such cases are likely to be those where the amounts involved are substantial, where the stock constitutes a major portion of the owner's assets, and where there is either no market, or a very thin and inactive market, for the stock. One study found that tax considerations were important in the sale of one tenth of the companies merged in 1940–47. They were important in about one fourth of all assets involved, and in one third of the assets of companies over $1,000,000. They were rarely a factor to the buying company.[6]

EFFECT OF COMBINATION ON PROFITS

Forty years ago, Dewing made one of the first studies of the effect of combination upon profits.[7] The industrial combinations studied were organized almost entirely prior to 1903, when mergers were mostly horizontal in character; and the major emphasis was placed upon size. Since that time, the type and form of combinations have changed materially; but the study is still useful in showing the possible adverse results of combination. Of the thirty-five industrial combinations analyzed, it was found that (1) the actual net earnings before combination were about 18 per cent greater than the earnings for the first year after their formation; and (2) the earnings for the entire ten-year period preceding combination were greater than the ensuing period by an amount of one fifth to one sixth. In this particular study, it is evident that the increased size did not produce greater earnings. At the same time, the analysis is comparatively limited in scope and does not necessarily reflect recent conditions.

A later and considerably more comprehensive study reached quite different conclusions. This study was based on over 300 cases of combinations organized in the period 1890–1904. The study showed that half the combinations were successful as measured by later earnings expressed as a percentage of capitalization. Their success was attributed to advertising that popularized trade-marked goods, continuous improvement in manufacturing and marketing methods, new products, and managerial ability.[8]

LIMITATIONS OF PROFITS TEST OF SUCCESS

The profits test of success is convenient and widely accepted, but there is some question as to whether it constitutes a sufficiently broad basis for

---

[6] J. Keith Butters and John Lintner, "Taxes and Mergers," *Harvard Business Review*, Vol. XXIX, No. 2 (March, 1951), p. 69.

[7] A. S. Dewing, "A Statistical Test of the Success of Consolidation," *Quarterly Journal of Economics*, November, 1921, p. 84.

[8] Shaw Livermore, "The Success of Industrial Mergers," *Quarterly Journal of Economics*, November, 1935, pp. 68–90.

satisfactory judgment. From the point of view of society as a whole, the profits measurement must be recognized as an index that gives money changes instead of real changes. Under certain conditions, there may be a marked increase in money profits without any appreciable increase in the goods or services that provide the standard of living so necessary for true social welfare.

Profits are of social consequence only to the extent that they bring forth productive effort. If, as a result of expansion or merger, prices were lowered or quality improved, society would benefit even though the profits were less. It must be admitted that combination is not likely to cause lower prices than prevailed under the previous conditions of competition unless a fair degree of competition remains or unless the elasticity of demand is such as to make lower prices more profitable. On the other hand, under some conditions, the combination may result in lower costs; and these may be passed on in lower prices. The automobile industry is an example of an industry in which combination has apparently made possible improved quality and competitive prices and has still permitted the payment of an adequate return.

During the history of the auto industry, more than 500 manufacturers of passenger vehicles have come and gone. Many of these companies failed because of the technical problems commonly associated with a new industry. Others failed because of inability to get or keep public acceptance, while still others disappeared as separate corporate entities via the merger route. Today, only five firms produce standard passenger cars; the "big three," Ford, General Motors, and Chrysler dominate the field, while Studebaker-Packard and American Motors represent recent mergers approved by the Department of Justice in the hope of strengthening the weaker companies as a means of maintaining at least a semblance of legal competition. Yet competition at the distribution level has been and remains intense. This has forced product improvements and design changes at a rapid rate. If the "big three" should ever combine under one central control, one may wonder if this would still be true.

Neither would the profits test necessarily reflect the comparative efficiency of management under combination as compared with previous independent operation. In the first place, the results may be affected by changes in the price level, which would have a pronounced effect upon the money earnings. The data could be made more comparable by correcting the results through the use of price-index numbers, but the price movements within a particular field rarely harmonize fully with general changes. Secondly, possible revision of expense items may have a decided effect upon profits. This contingency would be likely to arise in connection with salaries paid to the higher officials and in connection with the amount of depreciation recognized. Officers of the merged company would undoubtedly feel that they should receive higher salaries, and the

apparent earnings may be affected to a considerable degree through the depreciation account.

FACTORS ACCOUNTING FOR COMBINATIONS

In addition to the lure of profits, numerous other factors encourage the enlargement of business organizations. Among the more important are the following: (1) the natural process of elimination which follows the initial stages of most industries; (2) public favor of trade-marked or standardized commodities; (3) the ability of big business to attract capable management; and (4) difficulties in eliminating large, established businesses.

ELIMINATION FOLLOWING THE INITIAL STAGE

Any new industry is likely to attract more units than it is capable of supporting because the opportunities of a new field tend to create a ground-floor complex. Enterprising individuals yield to the temptation to get an early start and to share in the appreciation that often accompanies the transition from the initial stage to the more stable position of a mature industry. But many of these producing units disappear either through failure or as a result of their absorption by the more successful companies. Many start with inadequate capital and are receptive to any promising opportunity for retirement. Their interest may have been that of quick speculative profits as distinguished from longer-term operating profits.

The development of this natural tendency toward curtailment of the number of enterprises is influenced in large measure by the type and nature of the industry. Where a substantial capital investment is a prerequisite, there is apt to be less early mushroom expansion than where small units are adapted to the needs of the industry. While the tobacco industry is no longer new, it illustrates in an excellent way the significance and influence of the capital element. In 1958, there were 18 cigarette establishments with value of shipments of $2,159,987,000; and for the same year, there were 283 cigar establishments represented, with an output of $355,048,000. It is obvious that entry into the highly mechanized field of the former would be much more difficult than trying to get started in the latter, which operates on a comparatively small scale. This condition is sometimes referred to as a "capital monopoly," in that, although the industry may be free from restrictions as to patents or franchises, the very size of the capital requirements for initiating the new enterprise makes it extremely difficult for new competition to enter the field.

Patented or intricate processes also serve as a check upon the easy entry of new companies into a field. To illustrate, the Census of Manufac-

turers for 1957 estimated that there were 40 establishments engaged in producing synthetic fibers for that year, as compared with 32 for 1939 and 29 in 1929. Here, the influence of patented processes is coupled with rather large capital requirements to organize a single producing unit. In contrast, the producers of signs and advertising displays operated more than 2,725 establishments in 1958. In this case, there are rather small capital requirements and few, if any, restrictions upon the nature of production.

Artificial stimulation also appears to accentuate merger in the initial stages of industry through the ever-present promotion activities of the security houses and numerous enterprising individuals who are constantly on the lookout for quick profits. Trade association gatherings further contribute to a sense of industry consciousness which often paves the way for group action and, finally, for combination. In such an atmosphere the virtues of competition are usually forgotten and the paper advantages of combined effort magnified. Thus, the ground is laid for the formal merger of companies.

PUBLIC FAVOR OF STANDARDIZED COMMODITIES

Irrespective of operating efficiency, the ultimate test of business operations is to be found in the successful marketing of goods and services. Marketing methods vary of necessity according to the peculiarities of the products sold, but it is well known that price and quality are two common elements which facilitate sale. Emphasis upon price alone places tremendous pressure upon the cost of production; in addition, such a policy is likely to lead to a rapid turnover of customer clientele. Under the circumstances, it is not surprising that established companies should attempt to build up prestige by stressing the quality of their product. To do this, it is convenient to standardize the main lines of goods and to give them a label or trade-mark that may be cultivated on a national basis. Obviously, the applicability of the principle will depend upon the type of market that is being served. Thus, it is more serviceable in the case of consumer goods with wide distribution than with the products of heavy industries which encounter more selective buying.

Once a trade name is clearly established on a national basis, the demand for the product not only tends to increase; but it also tends to become stabilized, provided, of course, that advertising continues on its original scale and that no marked changes in competitive conditions occur. The extensive advertising campaigns which are so necessary for the development of patented or trade-marked goods can be conducted on a lower cost-per-unit basis if handled on a national scale. As a result, the branding of goods tends to encourage large-scale operation. In the first place, volume is virtually synonymous with large-scale production. Sec-

ondly, the stability of demand is a force that facilitates the carrying of overhead so commonly found in the large-scale organization.

One striking disadvantage of large-scale operations is found in the greater inflexibility of expenses. This arises out of the fact that the overhead expenses constitute a relatively large proportion of total expenses. Large-scale industry ordinarily results in a substitution of overhead expenses for direct and variable expenses—in other words, a substitution of machines for men. This will result in a more economical operation only if the scale of operations can be kept in proper relation to the capacity. When volume diminishes for any reason, the large-scale concern finds that many of its expenses continue, irrespective of the reduction in volume; whereas the smaller concern is better able to reduce its expenses to conform to its income. To offset the burden of fixed overhead expense, a large and diversified national market may offer substantial relief.

Because of the benefits of a trade name, it has become common policy to mold expansion programs around this convenient fiction. A railroad appeals to its market by telling the traveler that he will "sleep like a kitten"; moreover, the cat is given a name so as to give it popular currency. Long corporate nomenclature is too clumsy and forbidding for purposes of consumer use; hence the adoption of more human and convenient symbols. Similarly, products ranging from foods to automobiles are known by their trade names rather than by the companies that make them.

ABILITY OF BIG BUSINESS TO ATTRACT CAPABLE MANAGEMENT

It is frequently observed that the success of any business, big or small, is determined by the quality of its management. This is a truth that is not readily demonstrated by statistics because intangible values are not subject to empirical treatment. Moreover, the observation is made all too often from hindsight instead of from more profitable foresight. Nonetheless, in spite of such remote measurement of the management factor, its importance is commonly recognized.

Broadly speaking, big business has an advantage in the search for managerial talent. Not only do larger salaries serve as a practical lure, but the greater prestige of connections with large companies also exerts a powerful psychological appeal. Executives of big business are often national figures, but it is the exception for capable managers of small enterprises to achieve similar standing. In short, and perhaps unfortunately so, society attaches more prominence to positions with large companies than with smaller ones.

As we recognize the advantage that big business has in attracting capable management, we must also note that the problems and complexities of large-scale organization demand the most efficient direction. There are difficulties of organization and personnel administration which are not

equally present in small-scale enterprise. Instead of the direct supervision which is possible in the latter, authority is necessarily delegated in a degree directly proportional to the size of the operation. And delegated authority is seldom administered with the dispatch and exactness that accompany direct and immediate responsibility.

Another difficulty which seems to plague the managerial element of big business is that of providing for the perpetuation of good administration. This is caused by the fact that high-quality performance is due more to the qualities of the individuals who direct the operations than to the pattern of organization. Many large corporations have instituted training programs in an attempt to provide for replacements; but often, there exist some key individuals who furnish qualities of morale, inspiration, and genius which are not easily developed by training methods.

In view of these obstacles, we may well raise the question as to whether or not the ability of big business to attract capable management is, after all, a net advantage. The thought may be advanced that the attraction may be more than offset by the demands and pressures accompanying larger-scale organization. There is much merit in this contention; and to a great degree, it precludes ready generalization as to this point. However, this is a question of the relative efficiency of the size of the organization; whereas our inquiry is directed to the persistency of the movement in favor of increasing the scale of operation. From this point of view, outstanding leaders naturally seek the more challenging tasks of big business, for reasons previously set forth.

DIFFICULTIES IN ELIMINATING BIG BUSINESS

Once big business is established, it is not easily eliminated. This is caused by the widespread character of its ownership, which creates more extensive public interest than is true of smaller business units. As a consequence, when a large corporation gets into difficulties, it is usually reorganized. In contrast, small companies are usually liquidated. Their public following is limited, and their demise does not disturb the investment market or arouse public opinion. As a convenient illustration, when small banks failed by the hundreds during the decade of the twenties, little was done to afford positive relief. But when the larger banks started to fail in the early thirties, drastic steps were taken by the federal government to provide protection to the public at large. This went so far as to bring about the creation of the Federal Deposit Insurance Corporation in 1933 to insure the deposits of banks, both large and small.

This quality of survival by big business is not necessarily of long-term benefit to the whole economy. The situation may simply mean the perpetuation of business enterprise on an unsound basis. Because of this favoritism, for such it is, the increasing government influence upon and control of corporate reorganization is not surprising. The nature and ex-

tent of this government regulation will be described more fully in a later chapter.

COMBINATIONS CLASSIFIED BY PRODUCTS CONTROLLED

Our understanding of the basic factors underlying corporate combinations will be improved materially if we think of them in terms of the similarity or relationship of the products of the constituent companies. On this basis, the following groupings are found: (1) combination of a horizontal character; (2) combination of the integration variety; and (3) conglomerate combination.

Combination of a Horizontal Character. The most frequent type of combination is that wherein two or more companies producing the same kind of goods combine their operations under one management. This is often referred to as "horizontal" combination, since it represents a merging of concerns operating on the same plane. The usual reason for such linking of common activity is to secure benefits believed to inhere in operation on a larger and more closely integrated scale. In some instances, the chief purpose, veiled though it may be, is to obtain greater dominance or control in the field of enterprise. The combined group will constitute a larger portion of the total supply and may attain certain quasimonopolistic advantages in the markets. Greater diversification may also result because of the increase in the size of the market and because of geographical differences in the area of distribution.

Most horizontal combinations are of the specific type, that is, they are organized entirely in light of the existing situation and are completed in a single stage. At other times, the process of combination is more or less continuing in character. Thus, during 1928 and 1929, the Continental Can Company bought in each year eight other can or allied companies and merged their operations with the original concern. The expansion of the National Dairy Products Corporation has been exceptionally rapid due to the absorption of local concerns engaged in the dairy products business. Apparently the dairy business lends itself to mergers, because in the 1948–60 period Foremost Dairies, Inc. acquired fifty-nine smaller companies, Borden acquired thirty-five, while National Dairy Products added another fifteen concerns.[9]

Another variation in the combination of companies on a product basis is the uniting of companies having complementary or related lines. While combinations of the strictly horizontal type are effected primarily for the sake of operating efficiencies in terms of production cost or for control of the market, there are times when greater stress is placed upon possible economies in distribution and administration. To be specific, the organization of the General Foods Corporation, as such, did not necessitate an

[9] Federal Trade Commission, *Report on Corporate Mergers and Acquisitions*, p. 4; *Moody's Manual of Industrials*, 1961.

increase in size of the productive units. It is possible, however, that greater productive capacity may be necessary because a larger and more powerful organization may increase the sales of the individual units. Instead, the immediate result was simply that common and uniform administrative sales policies could be applied. The companies taken over by the General Foods Corporation in its early history would indicate the extent to which this statement is true: Jell-O Company, Inc.; Minute Tapioca Company, Inc.; Walter Baker and Company, Ltd.; Richard Hellman, Inc.; Log Cabin Products Company; Cheek-Neal Company; La France Manufacturing Company; Calumet Baking Powder Company; Certo Corporation; Frosted Foods Corporation; Diamond Crystal Salt Company; etc. Obviously, after such a combination, separate operating units with different production problems still remain. At the same time, it will be observed that common marketing and administrative policies may be applied to advantage, since all of its products reach the consumer through similar channels.

Again, in the merger of the American Radiator Company and the Standard Sanitary Company, the major economy to be achieved was in the process of distribution. Since both companies manufactured products for the building trade, it was quite convenient to offer customers sanitary equipment as well as heating apparatus. Also, on the production side, savings may be realized by the purchase of common metals on a larger scale or by introducing common methods of administration. More recently, Carrier Corporation, a leading manufacturer of air-conditioning equipment, acquired Affiliated Gas Equipment, Inc., an important manufacturer of heating equipment. From both a marketing and service viewpoint heating and air-conditioning equipment go together naturally. They tend to have complementary demand cycles, thus leveling out the companies' annual production. For similar reasons, manufacturers of office equipment should be able to offer their customers well-rounded lines instead of a single major appliance. Typewriters, adding machines, bookkeeping machines, and similar equipment require specialized, educated salesmen and trained servicemen. Hence, it is undoubtedly cheaper to sell and service this type of equipment on a complete-line basis instead of concentrating on a single product.

Integration. Quite frequently, the term "integration" is used in a general sense to cover both the horizontal and the vertical types of combinations. Horizontal combinations, as discussed above, are those arising out of merging operations of concerns having similar products in terms of production problems or marketing channels. Vertical combination, on the other hand, is a form of organization which brings together under common management various companies which produce goods having a supplementary relationship. Properly speaking, integration means a coordination, a fitting-together, or a summation of effort. Similarly, when used in a business sense, "integration" means a linking of successive steps or prod-

ucts which are found necessary in the production of goods or services. The process of combination involved here may function in two ways: (1) the postextension of activities, wherein the initiating company endeavors to get nearer to the consumer; and (2) the ante-extension of operations, wherein the activities are extended backwards toward the source of raw materials.

In the first of these plans, the company may wish to attain more effective control of the steps between itself and the ultimate consumption of its product. Manufacturers often find that when selling through independent distributors or manufacturers who carry on further processes, there is no assurance of maximum development of the interests of the original producer. Indeed, it is likely that middlemen will give first consideration to their own immediate benefits. Or it might be considered a form of profitable expansion to grow in a vertical instead of a horizontal manner. Consequently, there have been a number of mergers in which companies absorbed other companies which existed next in the channel of distribution of commodities to the ultimate consumer. For example, the Anaconda Copper Mining Company absorbed the American Brass Company; and the Kennecott Copper Corporation acquired the Pacific Brass Company. In both these cases, it seems apparent that the main objective of the initiating companies was to achieve greater control over the outlet of their products. Instead of stopping with the refining of copper, the next phase of operations—the production of brass and brass products—is entered into.

Integration of the ante-extension type provides greater control over the supply of raw material, the processes of production, and the means of transporting the products. Prominent examples of this form of integration are the United States Steel Corporation, the General Motors Corporation, the Ford Motor Company, and the United States Rubber Company. Thus, the United States Steel Corporation has extensive holdings of iron-ore reserves; large coal and coke properties; several railroad and water-transportation companies engaged in the transportation of raw materials to the mills; a large number of plants engaged in the production of steel in nearly all its forms (pig iron, steel ingots, wire, tubes, pipe, structural steel, etc.); natural gas properties; and others.

Conglomerate Combinations. A conglomerate combination occurs when a merger involves companies producing unlike articles. By unlike articles is meant articles having little or no common elements as they relate to raw materials, production technology, or marketing channels. General Motors Corporation is an example of a seasoned conglomerate combination. Its principal products are automobiles and parts and accessories for automobiles. In addition, it makes refrigerators, farm-lighting systems, electric motors, Diesel locomotives, lightweight railroad trains, and, most recently, road-building machinery. There is not too much basic similarity in these products, and the degree of success achieved can

be attributed only to the comparatively large-scale production of each product plus the company's highly successful system of decentralized management rather than to the fact of integration itself.

The objective of the usual conglomerate combination is to achieve a degree of diversification. The value of such diversification may express itself in the exploitation of profit opportunities, in tax advantages, or in a greater over-all stability of income. In the years since World War II, diversification has been more and more important as a factor in corporate combinations. In the 1948–54 period, one merger out of four could be classified as conglomerate in character.[10] What is striking about current developments is not the frequency with which conglomerate combinations occur, but the extreme diversity of products involved. The Glen Alden Corporation is a comparatively simple illustration. Originally incorporated as the Glen Alden Coal Company, an anthracite mining company, the company embarked on a diversification program in 1955 by acquiring the Mathes Company, a manufacturer of fans, heat pumps, and air conditioners. Later it purchased the Ward-LaFrance Truck Company, manufacturer of fire trucks and emergency rescue cars. At the same time, the Glen Alden Company reduced its coal operations and was reported to be taking tax losses through abandoning or selling at a loss some of its coal lands carried at high book values.

Subsequent events in the history of Glen Alden show that combinations, in and of themselves, offer no solution to financial problems. In 1958, the fire truck company was sold at a substantial loss and earnings on the air-conditioning operation had fallen nearly 75 per cent. Production rights on the coal reserves had been sold to provide additional financing. In April, 1959, Glen Alden merged with List Industries (which had held effective control). The resulting corporate set-up then ranged from motion picture houses through textile finishing and leather production to aluminum auto pistons—in addition to air conditioning manufacturing and real estate holdings.

A more extreme example of conglomerate acquisitions is provided by Textron, Inc. This company has followed a vigorous policy of expansion through the purchase of existing companies, either directly or through subsidiaries, and through organizing new operations, with the objective of providing balance against cycles in any one area of the economy.[11] Sales increased 100 per cent in the 1956–60 period, and the company now operates 90 plants in 21 states and Canada. Product lines include automobile upholstery products, polyurethane foam, engine blocks, camshafts; fiberglass boats, outboard motors, lawnmowers, golf carts, bathroom fixtures, cooking ware, work shoes; rocket engines, helicopters, nuclear research; machine tools, rolling mills and other metal working machinery; and fab-

---

[10] Federal Trade Commission, *Report on Corporate Mergers and Acquisitions* (Washington, D.C.: Government Printing Office, 1954), p. 4.

[11] *Annual Report*, 1960, p. 5.

rics made of synthetic fibers and wool. The textile business, providing 17 per cent of the company's sales and 24 per cent of its profits, was the company's original line of business.

Some of the recent corporate changes have represented more a matter of adaptation to economic environment than diversification as such. A case in point is the former A.C.F. Brill Motors Company. A formerly important manufacturer of busses, the company recognized that competition was proving too serious. The company sold its bus-manufacturing facilities, spun off its engine-building subsidiary to its stockholders, and went into the food-chain business. Today, it is the ACF-Wrigley Stores, Inc., operating food supermarkets supported by several food-processing operations to provide a measure of vertical integration.

Whether recent corporate developments of a conglomerate character represent the evolution of an entirely new kind of company remains to be seen. The desire for internal cyclical stability is undoubtedly real and largely achieved in some cases. Others represent an effort to utilize the high profits of a boom period. Still others represent the exploitation of a profit opportunity afforded by bringing new and more vigorous management to old concerns. To these factors must be added the influence of tax laws, especially as they relate to unused loss carry-backs. The real danger lies in the demands that diversification puts upon top management. Textiles, electronics, machinery, and firearms have radically different production techniques and distribution problems as do coal, fire trucks, and air conditioners. We have learned much about decentralization of management in recent years, but have we learned enough?

LARGE-SCALE ENTERPRISES AND PUBLIC OPINION

Aside from the purely business pros and cons, large-scale operation is also an attribute of business activity which easily assumes the qualities of a public issue. As a consequence, popular and political thought is likely to have pronounced influence in its acceptance or rejection. Since public opinion moves in cycles of moods, it is not surprising to find big business enjoying public favor at times, while at other periods it may be found in the well-known "dog-house." In the closing decade of the last century, distinct public aversion to monopolistic practices was crystallized in the form of legislation that was intended to outlaw undue curtailment of competition. Yet, in the decade immediately following, the aggression of big business was commonly accepted. Again, when big business was often credited with the stimulation of the business boom in the twenties, the formation of supersize business units was popular. Its castigation was equally prominent in the severe depression which followed.

Although public opinion is one of the great factors in the control of destiny, it is seldom developed in any logical manner. The decision rendered by public opinion may be right by virtue of the diversification of

mass judgment, but rarely is scientific diagnosis present. Instead, the presumption is that sufficient reasons will be found to substantiate the popular position. This accounts largely for the marked undulations of public opinion in its approval or disapproval of big business. When business activity is vigorous and prosperity abounds, the public cares little about the form of organization. Oppositely, when business is bad, somebody must be blamed. Consequently, dominance or control is presumed to carry the responsibility; and the onus is placed upon big business.

QUESTIONS AND PROBLEMS

1. "Dow Chemical, recently the strongest spot in the chemical group, is a good example of a firm which has grown at the expense of its balance sheet" (Carl M. Loeb, Rhoades & Co., *Fortnightly Review*, June 29, 1948, p. 4). Discuss the meaning of this statement, and comment generally on the problem of rapid expansion. Compare the 1948 balance sheet with the latest available report.
2. "Expansion is an attribute of the type of industry or product more than it is a product of management." Discuss.
3. Compare the methods that may be used for expansion: (*a*) enlargement of existing facilities, (*b*) purchase of assets of other companies, and (*c*) purchase of stock of other companies.
4. Distinguish between vertical and horizontal expansion.
5. In what respects does the trust arrangement differ from the usual delegation of authority by the stockholders to a board of directors?
6. "Large consolidated enterprises are a national safeguard in time of war emergency. Since the industries are already organized, the government is saved much time and effort in mobilizing industrial activity." Discuss.
7. "The chief reason why big business has better management than small business is because of the volume and the resources which make it possible to hire experts for each branch of activity." Discuss.
8. "Any combination of existing companies must necessarily be the cause of some restraint of trade. The only real question is whether it is believed to be reasonable or unreasonable." Under the circumstances, do you believe that prior approval by a public agency of combinations involving more than a prescribed amount of assets is desirable from the point of view of public interest?
9. "If free competition is destroyed, there is no escape from some form of control, and there is no other alternative than placing the control either in private hands or under some form of public supervision. Normally, such control is a prerogative of government and does not lend itself to private interests." Discuss the validity of this assertion, and also state whether or not you believe that other alternatives do exist.
10. Weak units with a large proportion of fixed capital are more likely to offer fierce price competition than those with only a small amount of fixed capital. Explain and discuss.
11. Occasionally, it is recommended that companies in a weak financial condition consolidate so as to form a stronger organization. What arguments may be advanced in support of this recommendation? Do you agree?
12. Study the report of the Federal Trade Commission entitled *The Merger*

Movement: A Summary Report (Washington, D.C.: U.S. Government Printing Office, 1948). Do you believe it reflects an economically dangerous trend? What, if any, are its political implications?

13. Compare the above report with the Federal Trade Commission's merger study published in 1955. Do you find any changes in concept or philosophy of regulation?
14. Study the development of the Merritt-Chapman & Scott Corporation and the evolution of its financial structure. What strengths or weaknesses do you believe have followed its acquisition program?
15. Compare the factors underlying the merger of Kaiser-Frazer and Willys Motors with those underlying that of Hudson and Nash.
16. Study the means by which American-Marietta Co. grew from 1955–60. Evaluate the methods in terms of economic benefit to society and profit motivation. Are the results "sound"?

REFERENCES

Butters, J. Keith; Lintner, John; and Carey, William L. *Effects of Taxation on Corporation Mergers.* Cambridge: Harvard University Press, 1951.

Dewing, A. S. *Corporate Promotions and Reorganizations.* Cambridge: Harvard University Press, 1914.

Federal Trade Commission. *The Merger Movement: A Summary Report.* Washington, D.C.: U.S. Government Printing Office, 1948.

———. *Report on Corporate Mergers and Acquisitions.* Washington, D.C.: U.S. Government Printing Office, 1955.

Gerstenberg, Charles W. *Financial Organization and Management,* chap. xxi. 4th rev. ed. Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1959.

Guthmann, H. G., and Dougall, H. E. *Corporate Financial Policy,* chap. 25. New York: Prentice-Hall, Inc., 1955.

Jones, E. *The Trust Problem in the United States.* New York: Macmillan Co., 1922.

Kaplan, A. D. H. "The Current Merger Movement," *Harvard Business Review* (May–June, 1955), pp. 91–98.

Mead, E. S. *Trust Finance,* chap. i. New York: Appleton-Century-Crofts, Inc., 1933.

Osborn, Richards C. *Corporation Finance,* chap. xxi. New York: Harper & Brothers, 1959.

Ripley, W. Z. *Trusts, Pools, and Corporations.* Boston: Ginn & Co., 1916.

Twentieth Century Fund, Inc. *How Profitable Is Big Business?* New York, 1937.

Chapter 29 ►

THE HOLDING COMPANY

THE HOLDING company is an outstanding example of the flexibility of the corporate form of organization. In terms of law, it is a legal fiction superimposed upon another legal fiction primarily for the purpose of facilitating control. More specifically, it holds or owns stock of other corporations in order to vote the stock and thereby achieve a common group policy without resorting to outright merger of the constituent companies. The top company is known as the "parent" organization or may be characterized as the "grandfather" or "great-grandfather" company, according to the degree of relationship. Also, the holding company may exist in pure form with practically all its assets consisting of stock issued by the subsidiary companies; or it may act in both a holding and an operating capacity.

PERSONAL FACILITY OR PUBLIC BENEFIT

The holding company brings into focus the very penetrating question of the nature and purpose of a corporation. Is it a personal facility solely? Or is it intended as a means of promoting the public welfare? In its early years, the corporation was deemed to be of such a public nature that, as noted in the discussion of the history of the corporation in Chapter 3, the charter was granted by special act of legislature. Then, increasing volume and other influences led to the practice of so-called free incorporation. Today, charters may be had almost for the asking—assuming, of course, that the incorporators are men of character and that they meet various technical requirements of residence and other miscellaneous features. Such freedom of action takes on added significance in the case of holding companies.

To give reality to the workings of a holding company, we may note some of the details of the Great Western Corporation, which was incorporated in the state of Delaware in June, 1955. The entire original issue of 100,000 shares of stock was acquired by the well-known investment banking firm, Lehman Brothers, at par for a total cash consideration of $100,-

000.[1] Shortly thereafter, the corporation borrowed $10,473,628 from a bank serving as an agent for a private investor, the latter being given an option to buy 42,500 shares of the original stock issue at $1.00 per share. On July 29, 1955, the Great Western Corporation bought the entire outstanding stock of the Great Western Savings and Loan Association and the stock of various affiliated escrow companies for $10,473,628. In late August, the corporation proceeded to sell 500,000 shares of stock to the public at a price of $23.50 per share, for a gross amount of $11,750,000. After underwriting commissions of $2.00 per share, the proceeds to the selling corporation were estimated to be $10,750,000, before deduction of other offering expenses estimated to be $57,350. As stated in the prospectus, the funds were to be used for the payment of the loan previously mentioned.

The participation of Lehman Brothers in the underwriting was 74,700 shares, which at a commission of $2.00 per share would provide a gross realization to this underwriter of $149,400, or $49,400 in excess of its original investment of $100,000 in the stock. In turn, the book value of the original offering by the Great Western Corporation is enhanced by the net proceeds of the stock purchased by the public. Specifically, the average book value of the stock after the public offering would be approximately as follows:

Original offering—100,000 shares @ $ 1.00	$ 100,000
Public offering —500,000 shares @ $21.50 (after underwriting commissions)	10,750,000
Total Proceeds—600,000 shares	$10,850,000
Book value per share	$18.08⅓

To note the results, it is clear that the stock for which the public paid $23.50 per share had a book value after completion of the offering of only $18.08⅓, but the promoting interests paid only $1.00 for this same stock.

Appraising holding companies in larger perspective, we may note the tenuous legal meaning of the common requirement that any single offering of stock must be on the basis of a uniform price; as seen above, there may be compliance by the use of a time interval of two or three months between different offerings. Also, thinking in terms of broad corporate and public policy, what is the significance of an arrangement whereby a California corporation—the Great Western Savings and Loan Association —becomes subject to the direction of a Delaware corporation—the Great Western Corporation? In this transaction, the amounts involved are comparatively small, but the underlying principle is applicable throughout the financial world. At stake, and of significance to both private interest and

[1] See *Prospectus, August 24, 1955*, of the Great Western Corporation; practically all of the ensuing data are based upon this same source. (The company's name was changed to Great Western Financial Corporation on May 18, 1956.)

public welfare, are the questions: Is the corporate device a private facility? Is it a public franchise?

CONTROL—A MEANS TO AN END

Although the facility of control is likely to stand out as a key characteristic of holding companies, it is important to recognize that control is simply a means to an end. In the case just cited the objective appears to be, in part, the facilitating of speculative profits in an area that is wholly unrelated to the normal business of the sponsoring interest. However, more generally, the basic aim is one of expansion of the scope of operations of the initiating party; specifically, the objective is one of developing integrated operating facilities. Under these conditions, the holding company plan may be used by small and large companies alike as a means of promoting new ventures or of acquiring an interest in existing companies. Also, it is significant that the liability or risk of the sponsoring company is limited to the extent of its investment—unlike the outright merger, which necessarily results in the assumption of the total risk.

There are many illustrations of the conveniences afforded by the holding company, as may be quickly seen by its actual use. For example, tire and rubber companies generally organize a new subsidiary company to acquire properties in foreign countries for the purpose of assuring a reliable source of their raw materials. Again, automobile companies may acquire controlling interests in existing mining or steel manufacturing companies; or they may organize new subsidiary companies to engage in these operations in order to obtain more efficient operation.

It is apparent that the purchase of a controlling interest in an existing, going concern has the advantage of permitting what may be termed "made-to-order" expansion. The risks may be readily appraised, and the expense and uncertainty of developing a new venture are avoided. Acquisition of the necessary stock is made particularly easy by purchase in the open market if the stock is listed and has diversified ownership; otherwise, there is the usual resort to negotiation, which is typical of outright merger.

THE FIELD OF ENTERPRISE

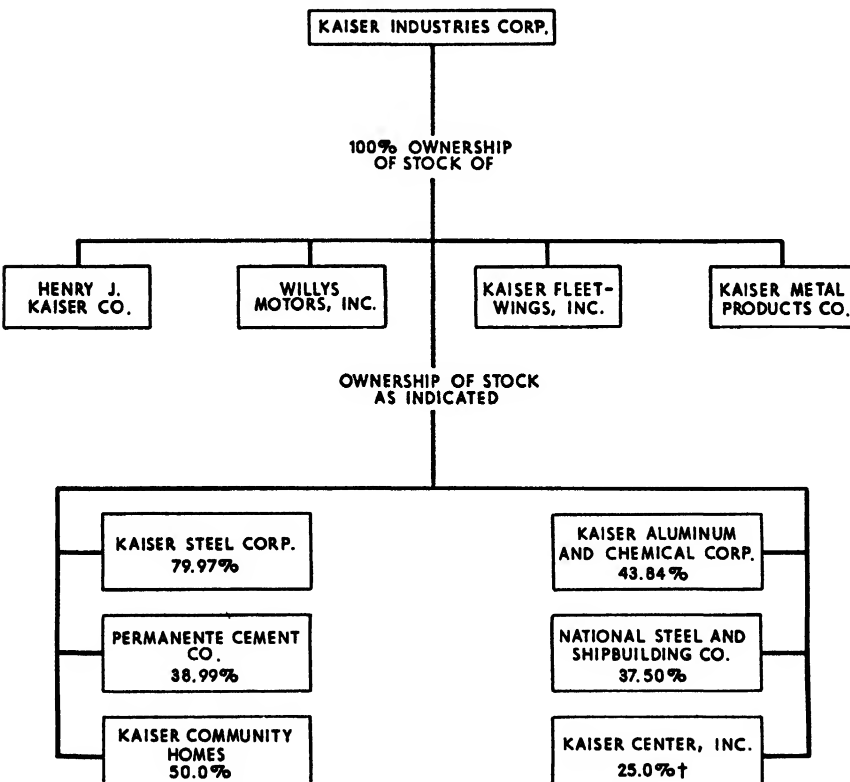
It is not surprising that holding companies are found in all three of the major fields of enterprise—industrial, railroad and public-utility. Often a company may function in both a holding and operating capacity, although this feature is most prevalent in the industrial segment. Not only is this latter condition the result of less regulation of the area by government, but, in addition, the diversity of activities invites use of the holding company principle to carry out programs of expansion. As indicated on other occasions, management frequently desires to enlarge the scope of

operations by the acquisition of supplementary or complementary facilities. This may be done either by outright merger or by control of the stock of the integral companies.

THE INDUSTRIAL AREA

Our appreciation of the workings of the holding company arrangement in the industrial area may be sharpened by recognition of a few examples. For long years, the well-known United States Steel Corpora-

FIG. 2. Summary Chart of Stock Owned by Kaiser Industries Corporation as of December 31, 1959*



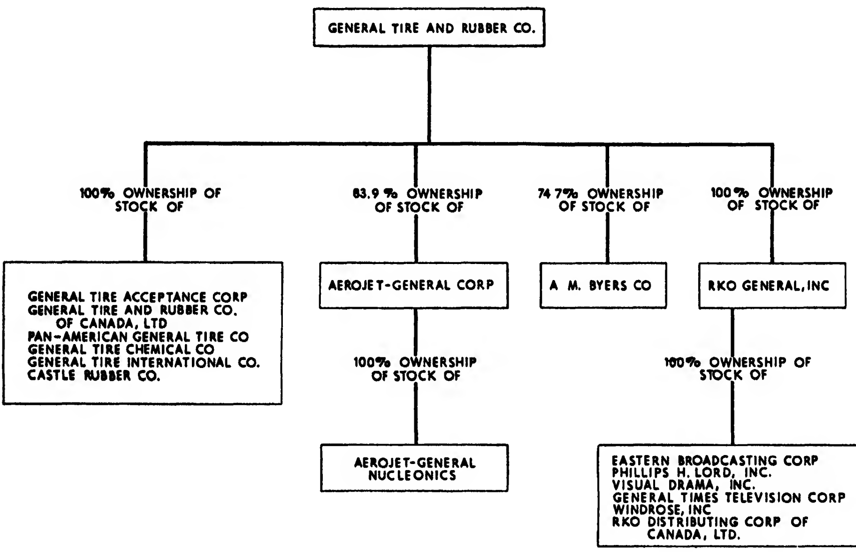
*See *Moody's Industrial Manual* (1960), p. 1097.
†Balance of stock owned by Kaiser Aluminum & Chemical, Kaiser Steel, and Permanente Cement.

tion was strictly a holding company, following which it initiated a program of merging its various subsidiaries into a compact operating structure. Specifically, in 1951, various companies were made a part of the United States Steel *Company;* then, in 1953, the latter was merged into the United States Steel *Corporation.* The former subsidiary companies

are now known as operating divisions of the parent organization; in addition, there are 10 operating subsidiary corporations (mostly mining and transportation) with 100 per cent of their stock owned by the United States Steel Corporation. In short, the latter is basically an operating organization but uses the holding company arrangement to conduct limited, supplementary activities.

An example of an industrial enterprise utilizing the holding company solely for control purposes is found in the so-called "empire" of Henry J. Kaiser. For the most part, it arose out of his far-flung activities during World War II and the postwar period. Not only does the plan of opera-

FIG. 3. Summary Chart of Stock Owned by General Tire and Rubber Company as of November 30, 1959*



*See *Moody's Industrial Manual* (1960), p. 1946.

tion reflect the freedom of corporate development that still exists in the industrial field, but it also portrays the familiar part played by a dominant personality. As shown in Figure 2, all of the common stock of the subsidiaries is held by Kaiser Industries Corporation in four instances, and control of the others is effected either by stock owned by subsidiary companies or by a dominant position of ownership by the parent organization. Appraising the over-all pattern, we may observe that the holding company principle is used to bring under common control a variety of diverse operating activities.

The General Tire and Rubber Company functions as an operating company to manufacture the products indicated by its name; also, it has acquired a number of other companies which, in some instances, are en-

gaged in operations which have little relationship to the parent organization. This may be seen in Figure 3, which further serves to bring into focus the economic purpose and underlying philosophy of the holding company. For example, should the control of RKO General, Inc. be considered as an operating outlet, or as the holding of stock for reasons of investment? Other pertinent questions are: To what extent should operating companies spread their activities for purposes of diversification? Are such arrangements just another way of seeking to make additional profits for the stockholders? To what extent should the purpose of a corporation be restricted to a specific area of activity?

RAILROAD HOLDING COMPANIES

In the railroad area, the holding company is a common phenomenon—particularly being used in conjunction with direct operations. Here, the contributions of the holding company toward expansion and integration are readily evident. Over a long period of time, the major railroad systems have acquired branch or feeder lines to round out their facilities; control of these subsidiary organizations is acquired by formal lease of the lines and equipment or by purchase of the stock ownership. By virtue of the voting rights inherent in the latter, the parent company is enabled to direct the operations so that they fit into the pattern of the integrated system. Occasionally, pure holding companies are found, such as the Delaware and Hudson Company, and, until recently, the Allegheny Corporation. However, there is less freedom of action for railroads than for industrials because of the broad regulatory powers of the Interstate Commerce Commission.

PUBLIC-UTILITY HOLDING COMPANIES

The holding company achieved its greatest prominence in the public-utility area. There are obvious benefits from integrating utility facilities of a single type that have reasonable geographical connection; however, as we shall discuss later in this chapter, the past record revealed many abuses of the motif of operation. We shall confine our further analysis of holding companies to the utility segment of business; but, at the same time, it should be kept in mind that many of the observations may, with proper modification, be applied to the industrial and railroad groups. Especially is this true with respect to public reaction to the cumulative pyramiding of the corporate structure as well as to the regulatory measures which may be demanded.

One writer has observed that "As proposals for federal incorporation grow more insistent, the holding company field may well become a laboratory in which are nurtured the bases for regulation of the distribution

policies of all American corporations engaged in interstate commerce."[2] Thus, in studying the holding company structure in the utility field, there is need for awareness of the possibilities of wider application in the future.

Over a period of years, and particularly during the twenties, vast utility empires came into being. The picture may be brought into focus by the following quotation from an annual report of the Securities and Exchange Commission:[3]

> It has been estimated that, from 1924 to 1930, utility holding companies floated some $5 billion of securities, the great bulk of which went not to build or improve utility properties but to purchase already outstanding voting securities of operating utility companies. The businesses of some of the companies acquired had no remote relationship to that of an electric or gas utility and one system even included a baseball team. The build-up, without any economic justification, of huge utility empires stretching across the nation was exemplified by one holding company which grew in gross assets from $6 million in 1923 to $1 billion in 1929, only to become insolvent and require years for its reorganization and rehabilitation—not, however, without tremendous losses to the investing public.

The resulting problems became a public issue between vested interests and social reformers, and the ensuing developments still pose many questions for management consideration. Our understanding and evaluation of the holding company in the public-utility field may be assisted by study of the following factors: (1) the value of the holding company as a form of organization; (2) the effect of the holding company upon the consumer; (3) the relationship between the holding company and the investor; and (4) the regulation of the holding company.

THE HOLDING COMPANY AS A FORM OF ORGANIZATION

The holding company is especially applicable as a form of business organization to the public-utility field. Originally, the utility market was local in character and was served by concerns whose operations were usually intrastate. Operation on this basis called for a comparatively small-scale corporate organization except in the larger metropolitan areas. Because of the monopolistic nature of the industry, some form of control was deemed essential for the protection of the public interest; and utility commissions were set up in the various states to provide the needed regulation. For our purposes, however, it should be stressed that, in the early stages of the utility business, both the operation and the regulation were predominantly of an intrastate character.

---

[2] "Federal Control over Corporate Distributions to Stockholders under the Public Utility Holding Company Act," *Yale Law Journal*, Vol. XLIX (1940), pp. 492–93.

[3] Securities and Exchange Commission, *Twenty-fifth Annual Report for the Fiscal Year Ended June 30, 1959*, p. xvii.

With the development of engineering and managerial techniques, it became apparent that operation on a larger scale would improve the operating efficiency. This could have been accomplished through outright consolidation of the various local companies or by some means of integration of operations through outside control which would still maintain the local identities. As a result of natural evolution, if nothing else, the latter course of action was chosen. In addition, this form of organization was intended to keep the operations on an intrastate basis as well as to avoid possible public antipathy toward large corporations.

Since the holding company may be justified as a convenient means of centralizing control or of facilitating administration, it would appear that the major point for consideration from the standpoint of public and financial policy is the extent to which the holding company setup may be carried beyond this primary stage. Actually, there was developed in many instances a super holding company structure in which several strata of controlling or combined holding and operating companies appeared.

THE SUPER HOLDING COMPANY STRUCTURE

Although it is perfectly clear that the integration of geographically adjacent operating companies can effect material economies in the cost of operation as well as improve the quality of service, it does not follow that the organization of a holding company for the purpose of controlling other holding companies can furnish any further economic savings. Yet, far-flung systems with little contiguity of the operating units were created, sometimes to the extent of having five or six layers of holding companies above the operating corporations.

Reacting to such conditions, one of the commissioners of the Securities and Exchange Commission observed:

> I cannot resist commenting upon the bewildering maze of corporations involved . . . and upon the labyrinthic course of the transactions themselves among these artificial beings, these corporate slaves called into existence by those who move them about and control them more completely than ever a master ordered the lives and acts of human slaves. The most remarkable aspect of it all is that through our legislatures' "liberalizing" of corporation laws and changing by statute the common law rules against intercorporate holdings, it is we ourselves who have made it possible.[4]

One of the most complicated utility systems was that of the Associated Gas and Electric Company, as may be seen in the outline of its corporate structure in Figure 4 (pp. 602–3). This giant system was the result of the acquisition or formation of more than 500 separate corporations. In December, 1940, the system comprised 172 companies, both holding and

[4] Commissioner Healey, *In the Matter of Equity Corporation*, 2 Securities and Exchange Commission 689 (1937).

operating and public-utility and nonutility. In some cases, as many as 5 companies intervened between the highest, or top, holding company and the lowest operating company. The system served an area having a population in excess of 7,000,000 persons, represented by 1,762,000 customers in some 6,200 communities located principally in New York, Pennsylvania, New Jersey, Virginia, South Carolina, Florida, and the Philippines. Many operating economies may have been gained through consolidating operating units in the more compact and densely populated areas of New York, Pennsylvania, and New Jersey; but it would seem that little additional gain could be obtained by welding such nonadjacent areas as South Carolina, Florida, and the Philippine Islands into the same system. Adding to the complexity and heterogeneity, the system furnished practically all forms of utility service—electric, gas, water, transportation, and ice. Here was an organization that was largely the result of financial maneuver, and its economic unsoundness was demonstrated all too forcefully by its own insolvency.[5]

Even with a minimum of layers of corporations, the holdings of securities by the public may assume one of three possible patterns: (1) issues which are primarily the obligations of the operating subsidiaries; (2) issues which are primarily the obligations of the holding companies; or (3) a mixture of obligations of both the operating and holding companies. Under the last of these three plans of financing, there is "a pyramiding of system securities which was one of the evils the Public Utility Holding Company Act of 1935 was designed to prevent."[6]

Illustrative of the actions taken by the Securities and Exchange Commission to carry out the intent of the law is its treatment of the Columbia Gas System, Inc. During the fiscal year ended June 30, 1959, one of its wholly owned subsidiaries—Columbia Gulf Transmission Company—acquired the assets of Gulf Interstate Gas Company. The former issued 3,574,337 shares of common stock to obtain the assets and, in addition, assumed the liabilities of the latter. Included in these liabilities were $141,-400,000 first-mortgage bonds owned by the general public. Because the Columbia System had followed a policy "of having its publicly-held securities solely at the holding company level," the Commission required corrective measures; as a result, obligations of the holding company were issued in exchange for those of the subsidiary.[7]

[5] Petition for reorganization under the Bankruptcy Act was filed in 1940, and the company is now known as the General Public Utilities Corporation. By order of the Securities and Exchange Commission, issued August 13, 1942, it was required to dispose of its interests in 116 companies. As of June 30, 1946, the divestment of these holdings was almost complete; see Securities and Exchange Commission, *Twelfth Annual Report for the Fiscal Year Ended June 30, 1946* (Washington, D.C.: U.S. Government Printing Office), pp. 57–60.

[6] *Twenty-fifth Annual Report, op. cit.*, p. 126.

[7] *Ibid.*

THE HOLDING COMPANY AND THE CONSUMER

The chief interest of the consumer in a holding company is in its effect upon the rates charged and the quality of service. Holding companies contend that rates have been reduced as a result of their efforts, but many people are inclined to believe that the reductions have been inadequate in frequency and amount.

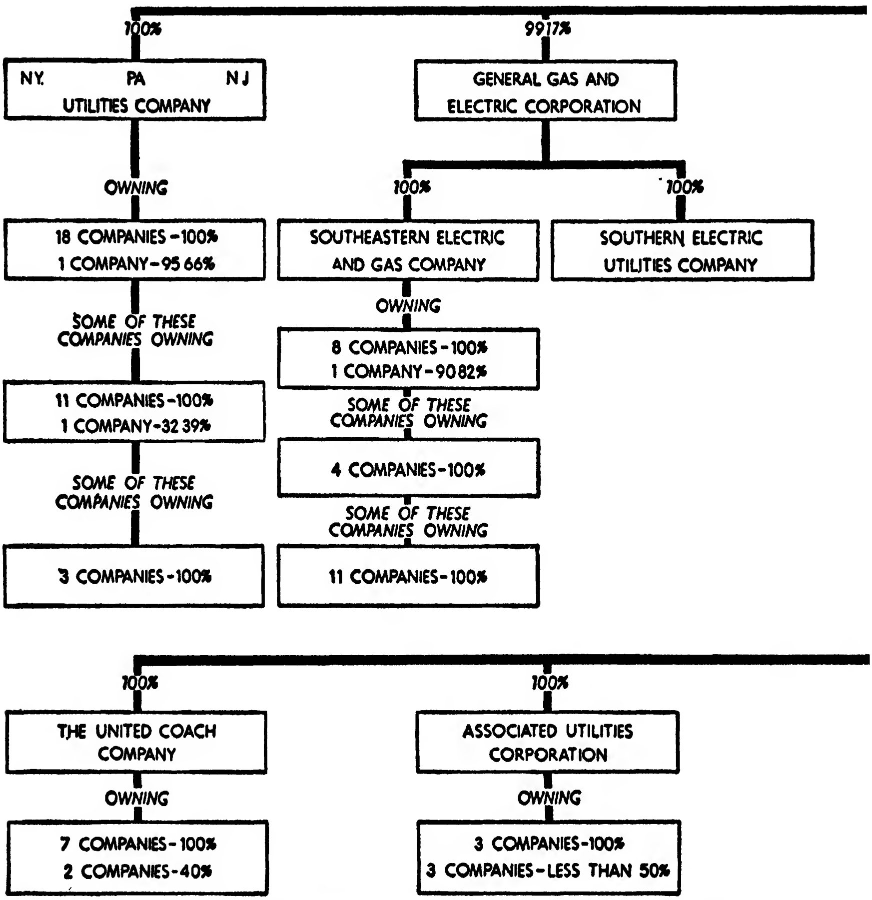
To show that the holding company has been responsible for reduced rates, the present rate structure is often compared with the charges made during an earlier period. The trend in the prices of practically all utility services was downward until prosperity and inflationary pressures of the period following World War II brought it to a halt, but this does not constitute absolute evidence that the holding company was responsible for the change. This is especially true of the super holding company structure, which is more of a financial device than a means of assistance in the technical process of production. In other words, it is fair to assume that at least a portion of the rate changes may be attributed to technological developments which would have been forthcoming irrespective of the form of organization used to control the operating companies. Moreover, many operating companies were of sufficient size to bring about technical improvements without outside assistance; and a single holding company would have been adequate to make the improvements available to the smaller companies.

As further evidence of the holding company's part in lowering rates, other advantages—such as savings made possible by large-scale buying, common use of improved methods of operation, and the engagement of expert and better-trained management—are set forth to show why the cost of production has been reduced. There is no denial of many of these advantages, but the degree to which some corporate structures have been pyramided requires more justification. Certainly a simple one-layer arrangement makes possible these savings and, at the same time, avoids the maze of intraorganizational expenses which are likely to arise from the red tape of large and complicated corporate systems. As we shall see later in this chapter, the development of a pattern along these lines has now largely been accomplished as a result of the workings of the Public Utility Holding Company Act of 1935. For example, as of December 31, 1959, the Columbia Gas Systems, Inc. owned directly 100 per cent of the stock of 16 operating subsidiaries and 72.48 per cent of one other; this simple organization stands in marked contrast to its corporate structure in the twenties when it held subsidiaries "in depth" or in a number of layers.

The relationship between capitalization and rates is also of significance when considering the effect of the holding company upon the consumer. Admittedly, the holding company does result in piling security stratum upon security stratum until many dollars of securities exist for each dol-

lar of plant and operating assets. Would not such a condition demand higher returns in order to support the heavier capital structure? In the simpler aspects of the problem, the pyramiding process, in and of itself, does not create such a demand. After all, the securities of the holding company are not necessarily net accretions to the security supply. In-

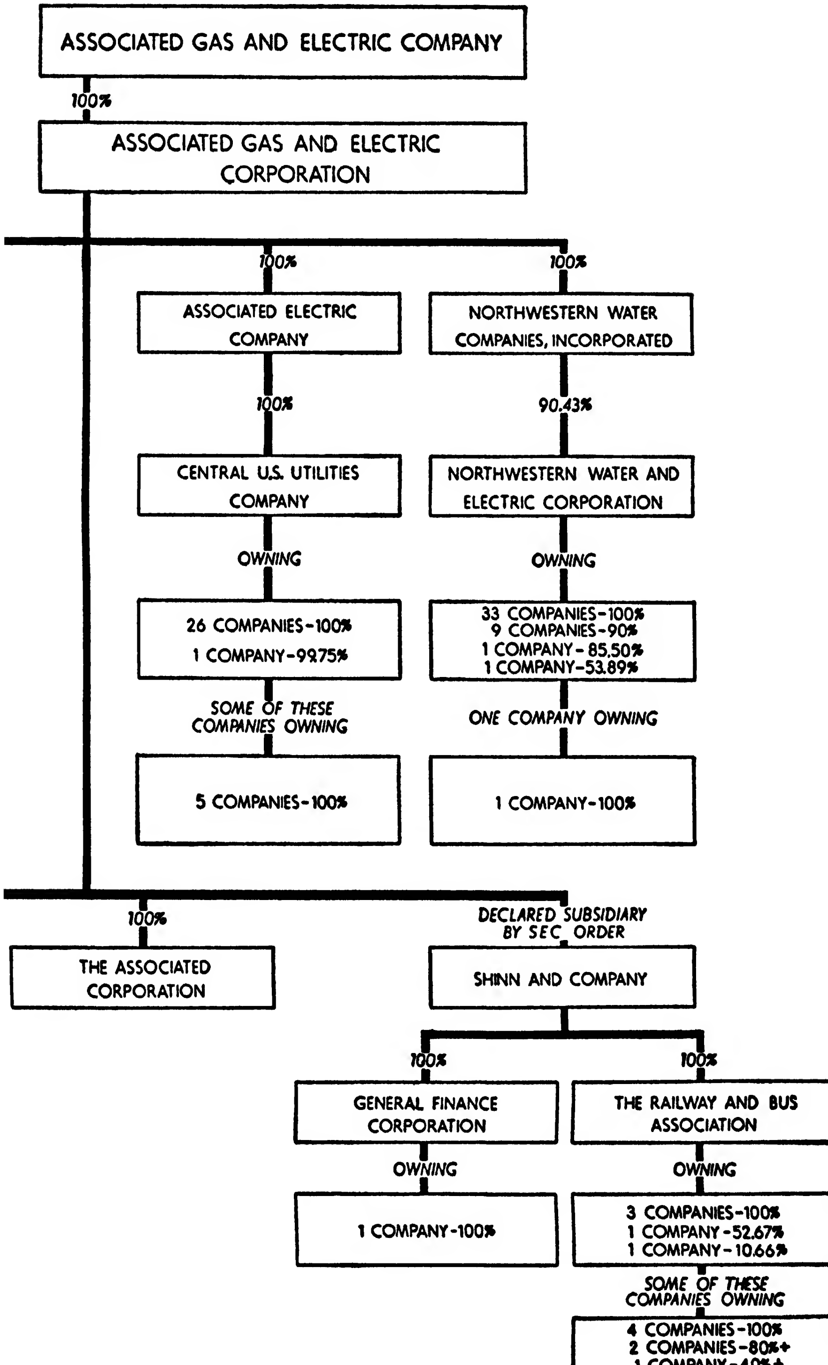
FIG. 4. Percentage of Voting Security Ownership—Associated Gas and Electric System



Source: Adapted from Securities and Exchange Commission, *Holding Company Act Release No. 3042,* October 1, 1941. This chart is presented only in bare outline and is subject to qualifications shown in the original source.

stead, they may be purely offsetting in character, in that they represent other securities. The income accruing to the securities owned as assets by the holding company is at the same time the source from which dividends and interest may be paid on the securities issued by the holding company.

Actually, it is difficult to establish any precise relationship between the capitalization of the holding company and the rate structure of the operating companies. Since the stocks of the latter are controlled by the


ASSOCIATED GAS AND ELECTRIC COMPANY
100%
ASSOCIATED GAS AND ELECTRIC CORPORATION
100%
ASSOCIATED ELECTRIC COMPANY
100%
CENTRAL U.S. UTILITIES COMPANY
OWNING
26 COMPANIES-100%
1 COMPANY-99.75%
SOME OF THESE COMPANIES OWNING
5 COMPANIES-100%
100%
NORTHWESTERN WATER COMPANIES, INCORPORATED
90.43%
NORTHWESTERN WATER AND ELECTRIC CORPORATION
OWNING
33 COMPANIES-100%
9 COMPANIES-90%
1 COMPANY-85.50%
1 COMPANY-53.89%
ONE COMPANY OWNING
1 COMPANY-100%
100%
THE ASSOCIATED CORPORATION
DECLARED SUBSIDIARY BY SEC ORDER
SHINN AND COMPANY
100%
GENERAL FINANCE CORPORATION
OWNING
1 COMPANY-100%
100%
THE RAILWAY AND BUS ASSOCIATION
OWNING
3 COMPANIES-100%
1 COMPANY-52.67%
1 COMPANY-10.66%
SOME OF THESE COMPANIES OWNING
4 COMPANIES-100%
2 COMPANIES-80%+
1 COMPANY-40%+

former, it follows that dividend and financial policies are largely dictated by the parent company. There may be pressures exerted to raise the rates in order to increase the dividends; but, in the last analysis, the rates would be subject to approval by the state utility commissions and to court review. Without becoming too involved in the process of rate determination, it may be said that the courts now try to rationalize rates on the basis of all the factors involved. There is "consideration of the interests, not only of the consumers, but also of the investors, in order that returns on investments may be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."[8]

THE HOLDING COMPANY AND THE INVESTOR

It should be observed that the holding company plan does incorporate and make use of one of the basic principles of investment, namely, diversification. Obviously, not all the possible types of diversification are involved; but the distribution of risks along geographical lines is obtained and, to a lesser extent, by types of industries. Although little may be gained, from an operating point of view, by including hydroelectric, steam electric, gas, water, and transportation companies within one holding company group, such a procedure does afford an appreciable distribution of risk. Greater stability of income may be found in one type of activity than in another, and expansion in some may compensate for retrogression in others. It would appear that such balanced operation would offer a substantial basis for the issuance of securities and would constitute a highway of comparative safety for the investor. In the face of this, how can the status of investors who have experienced large losses as a result of investing in the holding company be explained? The answer is to be found not in the application of the principle of diversification but rather in certain financial abuses arising out of the pyramiding of company on top of company and the practice of excessive trading on the equity.

The establishment of a primary holding company, that is, the company immediately above the operating company, does afford a desirable type of diversification aside from the convenience permitted in the way of control. Beyond this point, no fundamental diversification is achieved, inasmuch as little distribution of risk may be accomplished by simply holding securities of other holding companies within the existing system. In fact, it is possible that the creation of secondary holding companies may more than offset certain savings by adding to the cost of administration and other overhead expenses.

---

[8] *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944). Also see Emory Troxel, *Economics of Public Utilities* (New York: Rinehart & Co., 1947), chaps. xii and xiii.

The feature that is most disadvantageous to the best interests of the investors, however, is that of excessive trading on the equity when a fixed charge is substituted for a contingent one. The temptation to indulge in the practice is further encouraged by the possible cumulative effect upon profits. This may be illustrated by the assumed case shown in Table 63.

TABLE 63

THE EFFECT UPON INCOME OF PYRAMIDING HOLDING COMPANIES

Operating Company		
Assumed capitalization:		
5 per cent bonds held by the public		$ 60,000,000
6 per cent preferred stock held by the public		20,000,000
Common stock held by first holding company		20,000,000
Total outstanding securities		$100,000,000
Net return (assume that a fair return is 8 per cent and that the valuation base is $100,000,000)		$ 8,000,000
Less (ignoring operating expenses):		
Bond interest at 5 per cent	$3,000,000	
Preferred dividends at 6 per cent	1,200,000	4,200,000
Available for common stock—19 per cent		$ 3,800,000
First Holding Company		
Assumed capitalization:		
6 per cent bonds held by the public		$ 8,000,000
7 per cent preferred stock held by the public		7,000,000
Common stock held by second holding company		5,000,000
Total outstanding securities		$ 20,000,000
Income—dividends from operating company		$ 3,800,000
Less (ignoring operating expenses):		
Bond interest at 6 per cent	$ 480,000	
Preferred dividends at 7 per cent	490,000	970,000
Available for common stock—56.6 per cent		$ 2,830,000
Second Holding Company		
Assumed capitalization:		
6 per cent bonds held by the public		$ 1,500,000
7 per cent preferred stock held by the public		1,500,000
Common stock held by controlling interests		2,000,000
Total Outstanding Securities		$ 5,000,000
Income—dividends from first holding company		$ 2,830,000
Less (ignoring operating expenses):		
Bond interest at 6 per cent	$ 90,000	
Preferred dividends at 7 per cent	105,000	195,000
Available for common stock—131.75 per cent		$ 2,635,000

Operating expenses have been ignored in these calculations in order to obtain simplicity for purposes of illustration and to emphasize the effect that trading on the equity by a holding company may have upon profits. The principle is equally applicable whichever direction the trend of income may take. In the event that the earnings and dividends of the operating company should increase, the ultimate effect upon the earnings per share of the common stock of the holding company is more than proportional. In like manner, diminishing income would tend to compound itself to the disadvantage of the holding company.

Similar consequences appear in connection with any changes in the value of the securities held by the holding companies. Thus, if the value of the operating company's common stock should materially increase, the benefits would accrue to the common stock equity of the holding company, since the preferred stock and bonds are established upon a fixed basis. Again, if the value of the stock of the operating companies decreased, the common stock equity of the holding company would stand the loss up to the point where its equity was destroyed. At this juncture, the preferred equity would be affected; and, if the decline were large enough, it would ultimately reach the bondholders.

It is also apparent that the more removed the holding company is from the operating base, the more serious are the foregoing effects. The lot of the bondholders of the secondary holding companies may prove to be an unhappy one. At no time would they benefit from an increase in the income of their company, but their position would become quite vulnerable in the event of a major decline in the income. The failure of investors to perceive this weakness is largely due to what might be called the "bond complex." Many persons are inclined to regard bonds as better investments than common stocks, and too little attention is given to the basis upon which the bonds may be issued. From a strictly legal point of view, a bond of a holding company does contain protective features usually incorporated in securities of this type; and, frequently, the higher yield of such bonds proves to be very inviting. Yet, the basic economic setting of the bonds of holding companies is inherently weak; and this weakness cannot be avoided by the insertion of legal frills. Under these conditions, it may appear logical, in the interest of public policy and for the welfare of the investor, to restrict the extent to which holding companies may trade on the equity. The problem relates more especially to the general question of government regulation of holding companies and may be discussed to better advantage in this connection.

GOVERNMENT REGULATION OF THE HOLDING COMPANY

Prior to 1935, there had been little effective regulation of public-utility holding company activities by any governmental agency. This condition was caused largely by uncertainty as to whether the responsibility for regulation should be in the hands of the federal or state governments. The answer depended chiefly upon determining whether the holding company could be regarded as engaging in a public-utility business and whether the operations were interstate or intrastate in character.

The federal regulation of the public-utility business (other than railroads) was a distinct innovation, and it is not surprising that vigorous debate accompanied the issue. The discussion was limited primarily to holding companies, and we may note the pro and con arguments which were advanced. Advocates of reform stressed the following:

1. Even though the specific operations of the holding company may not be interstate in character, the policy controlling all of its subsidiaries may be decidedly so. Certainly, the control of a subsidiary company located in another state involves policies that cross state lines.
2. The very size of many holding companies renders state regulation practically impossible and makes federal regulation necessary.
3. The financing of the subsidiaries and holding companies is usually an interstate transaction.

The opposition countered with the following points:

1. Holding companies engage primarily in intrastate business; and, except where the physical service of controlled operating companies actually crosses state lines, the federal government should have no voice in the matter.
2. In many instances, the imposition of federal regulation would mean a duplication of services now being performed by the regulatory commissions of the states. This conflict of authority might prove to be costly and confusing.

Admittedly, it is never easy to make a sharp and precise distinction between interstate and intrastate commerce. The line of demarcation is not clear and tends to shift with the development of the economic philosophy of the country. There is no question of commerce, as usually defined, in the activities of holding companies; and, clearly, the holding companies are not public utilities subject to regulation under the common law, since they furnish no services to the public. Practically, however, holding companies do carry on interstate operations, at least in financing, and do influence the physical operations of local companies so as to render their regulation virtually impossible if the holding companies themselves were not made subject to control.

In the end, disagreements on business and other forms of private rights are settled by the courts; and, in this instance, the final answer was provided by the Supreme Court of the United States in 1946. Rendering its verdict in the settlement of a leading case,[9] it gave expression to the following views:

1. The relationship of a corporation owning stocks in public utilities corporations toward such companies cannot be deemed to be merely that of a large investor seeking to promote the sound development of its investments. . . .[10]
2. The power of Congress over interstate commerce is the power to regulate, and is complete in itself, may be exercised to its utmost extent, acknowledges no limitations other than are prescribed in the Constitution, and extends to every part of interstate commerce and to every instrumentality or agency by which it is carried on; and the full control by Congress of the subjects committed to its regulation is not to be denied or thwarted by the commingling of interstate and intrastate operations.[11]

---

[9] *North American Co.* v. *Securities and Exchange Commission*, 90 L. Ed. 945.

[10] *Ibid.*

[11] *Ibid.*, p. 946.

This case resulted from the enforcement of the Public Utility Holding Company Act of 1935, which may now be analyzed in some detail because of its broad significance to holding companies and to corporate financial policy generally.

THE PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

The far-reaching intent of the Public Utility Holding Company Act of 1935 is indicated by the extremely broad definition of a holding company, viz.:

> (A) any company which directly or indirectly owns, controls, or holds with power to vote, 10 per centum or more of the outstanding voting securities of a public utility company or of a company which is a holding company by virtue of this clause or clause (B), unless the Commission, as hereinafter provided, by order declares such company not to be a holding company; and (B) any person which the Commission determines, after notice and opportunity for hearing, directly or indirectly to exercise (either alone or pursuant to any arrangement or understanding with one or more other persons) such a controlling influence over the management or policies of any public utility or holding company as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such person be subject to the obligations, duties, and liabilities imposed in this title upon holding companies.[12]

Before declaring the limitations upon holding company activities, the act stipulates that the following organizations are exempt: (1) those organizations whose operations are predominantly intrastate in character; (2) those companies which engage in the utility business only incidentally to some other major form of activity; (3) miscellaneous companies which hold the securities of public-utility companies for purposes of liquidation, underwriting, etc.

As a prerequisite to the supervision and regulation of holding company activities, it was necessary to assemble comprehensive information relating to the companies affected. This was accomplished by the requirement that they should register with the Commission on or before December 1, 1935.[13] The act stipulated that failure to register made it unlawful to engage in virtually any form of interstate activity, including manufacture and distribution of gas or electric energy; performance of service contracts; public offering of securities of either the holding company or a subsidiary; or "to own, control, or hold with power to vote any security of any subsidiary company" which engages in such activities.

The industry was by no means unanimous in proceeding to register, and numerous utility organizations contended that the act was unconsti-

---

[12] Public Law No. 333, 74th Cong., S. 2796.

[13] The term "Commission" is used to mean the Securities and Exchange Commission. When reference is made to the Federal Power Commission, it will be designated by its complete name.

tutional. Reflecting somewhat the tenseness of the issue, the chairman of the Commission said in a radio address over a nationwide hookup:

> We assume our responsibilities in an atmosphere still surcharged with the passionate feelings and unnecessary fears aroused by the legislative battle that preceded the passage of the Holding Company Act. At the outset we find that the very authority entrusted to the Commission by the Congress of the United States is challenged upon constitutional grounds by the public utility industry.[14]

The issue was clarified by the United States Supreme Court in a case that had been initiated by the Commission against the Electric Bond and Share Company for failure to register. This particular holding organization, with total assets of more than $3,000,000,000, controlled nearly 15 per cent of the private electric power industry. The court rendered its decision on March 28, 1938, with a vote of six to one. It upheld the constitutionality of the provision requiring registration but refused to separate the other sections of the act for purposes of special consideration.[15]

COMPARISON OF HOLDING COMPANY ACT AND SECURITIES ACTS

It is helpful to compare the primary objectives of the Securities Act of 1933 and the Securities Exchange Act of 1934 with those of the Public Utility Holding Company Act. The securities acts are intended to insure fair and honest disclosure of facts but do not provide for positive control of financial practices. In a sense, their chief purpose is to promote fair trade practices but still to permit private management to exercise final judgment. The Public Utility Holding Company Act is distinctly regulatory in character and provides for active supervision of the industry. To show the significance of the difference in scope of the securities measures and the Public Utility Holding Company Act, the following comparison of express powers may be noted:

1. Under the utility act, the Commission could prohibit the sale of preferred stock and other securities on the grounds that they were not financially sound; under the Securities Act, it could compel only the disclosure of facts.
2. The utility act gives the Commission broad authority to regulate the financial programs of utility companies. The two securities acts require simply the filing of reports; and their effectiveness depends upon the liabilities of directors, officers, and other parties of interest for misleading statements, etc.

The control of holding companies and the direction of their financial practices generally are placed under the Securities and Exchange Commission; whereas operating problems (rate determination, valuation, etc.) are placed under the jurisdiction of the Federal Power Commission. Since

---

14 Speech by Chairman James M. Landis, September 28, 1935.

15 *Electric Bond & Share Company* v. *Securities and Exchange Commission*, 303 U.S. 419 (1938).

our chief interest is found in corporate organization and financing, the analysis will be confined mainly to matters under the jurisdiction of the Securities and Exchange Commission. Here, the following two major objectives are paramount: (1) regulation of the sale of new security issues of holding companies and their subsidiaries and (2) simplification of holding company systems.

REGULATION AND SALE OF NEW SECURITY ISSUES

Under Sections 6 and 7 of the act, securities may be issued only upon the Commission's approval. Technically, a registered holding company or the operating subsidiary files a declaration covering a proposed issue which does not become effective until formal assent is given by the Commission. Before this is given, the issue is checked not only as to its general soundness but also as to certain features relating to the methods by which the securities are to be sold. Three tests are set forth in Section 7 (*d*) to cover the former:

1. The security proposed for sale must be "reasonably adapted to the security structure of the declarant and other companies in the same holding company system."
2. Proper relationship between the security issues and the "earning power of the declarant" must be established.
3. A more general test is found in the broad requirement that the issue must be "necessary or appropriate to the economical and efficient operation" of the business of the applicant.

In passing upon new security issues, the Commission has recognized the need for variation in standards between new securities and refunding issues.[16] This differentiation is a matter of practical expediency because refunding may be compelled by the maturity of existing debt; and, moreover, it effects little change in the *status quo*. However, both new and refunding issues are tested in the light of requirements established under Section 7(*d*) and may be rejected if the debt ratio is believed to be too high or if other pertinent reasons exist, such as the inadequacy of earnings to carry the capital burden.

Consumers Power Company. It is fairly clear that the Commission is encouraging greater use of equity (common stock) financing, a point which is well illustrated in the Consumers Power Company case.[17] In this instance, the company sought permission to sell thirty-year first-mortgage bonds amounting to $28,594,000 and 125,000 shares of no-par common

[16] William R. Ethridge, "Administrative Policy toward Security Issues under the Public Utility Holding Company Act," *Mississippi Law Journal*, Vol. XIII (1941), pp. 166, 176–80.

[17] Securities and Exchange Commission, *Holding Company Act Release No. 1854* (1939).

stock. In order to understand the action of the Commission, it is necessary to note the purpose for which the funds would be used. The proceeds from the bonds were to be distributed as follows: $18,594,000 to refund outstanding bond issues and $10,000,000 to cover expenditures previously made from the treasury of the company for additions to property. The stock proceeds, amounting to $3,524,187.50, were also to be used for the latter purpose.

The Commission approved the securities with the exception of the $10,000,000 of bonds, the proceeds of which were to be used to finance new improvements of the plant. It was believed that this financing could have been effected through the use of common stock at reasonable terms and that the use of bonds was unnecessary. The Commission admitted that proper consideration should be given to managerial judgment but asserted its own duty to enforce the standards of the act. In this instance, it was considered appropriate to apply Section 7 (*d*) (3), which authorizes rejection if the Commission finds that the "financing by the issue and sale of the particular security is not necessary or appropriate to the economical and efficient operation of a business. . . ."

In support of its position, the Commission contended that the company's ratio of common stock and surplus to total capitalization was only 20 per cent and that this was less than the ratios of numerous other companies operating in the same general area. Although the company admittedly had a good earnings record in the past, the contingency of future changes suggested the use of a more conservative financial program. In view of these findings and other related circumstances, it was considered that the type of financing was not "necessary or appropriate."

Public Service Company of Colorado. In another case, funded debt which appeared to be excessive was permitted because of various other offsetting conditions and was further facilitated by the attachment of stringent limitations on future dividend payments.[18] The common stock of the declarant had been obtained by the parent holding company without cash consideration, and the question of whether or not there were sufficient asset values to support the capital structure was most pertinent. Indeed, it was declared that "the consolidated property accounts of the declarant, aggregating $86,885,793, contained $23,424,418 of inflationary items." Despite this condition, the new financing was approved because the program would bring about material savings in interest charges and would effect improvement in the capital structure by accelerating the rate of debt retirement.

---

[18] Securities and Exchange Commission, *Holding Company Act Release No. 1071* (1939). See also Securities and Exchange Commission, *Sixth Annual Report for the Fiscal Year Ended June 30, 1940* (Washington, D.C.: U.S. Government Printing Office), p. 25, for brief summary. Also, see *Moody's Manual of Public Utilities, 1947*, p. 1589; and *Moody's Public Utilities Investors Service,* May 21, 1947, pp. 1267–68, for details of major refinancing in 1947.

INFLUENCE ON OPERATING POLICIES

In approving new security issues as well as other adjustments of the capital account, the Commission frequently imposes certain conditions on operating policies as a means of safeguarding the long-term capital structure. Two common requirements are those relating to the creation of adequate reserves or provisions for maintenance and the limitation of dividend payments. Broadly speaking, two methods are available to encourage a more rapid accumulation of reserves:[19] (1) to condition the approval of a new security issue upon the formal adoption of a satisfactory depreciation and maintenance program and (2) to use moral suasion to have provisions covering maintenance and depreciation written into indentures that accompany security issues.

An illustrative case is that of the Southern Utah Power Company, which applied for permission to sell bonds. Among the conditions required for final approval was that the company would expend for maintenance and repairs at least 17½ per cent of its gross operating revenue (after certain deductions). Another example is that of the Northern States Power Company (Wisconsin), which sought exemption from the act for the sale of 25,327 shares of common stock and $1,703,000 of bonds of one of its subsidiaries. Approval was conditioned upon an agreement not to pay dividends unless expenditures for maintenance and repairs met a prescribed standard.[20]

Commission control over managerial discretion is especially outstanding in the application of the former Columbia Gas and Electric Corporation to revise its capital structure.[21] Here, permission was sought to write down the stated book value of the common stock from $194,349,005 to $12,304,282. The difference of $182,044,723 was to be credited to a special capital surplus account, which was to be used to write down various debatable assets which had been established prior to December 31, 1937. One of the objectives was to free current earnings for purposes of preferred dividends, which had previously been subject to the approval of the Commission.

The assent of the Commission was granted subject to six conditions, two of which reflect upon managerial authority. In substance, these are as follows:

1. Retention by the Commission of control over dividends on the common stock. Here, it was specified that dividends could not be paid unless, after providing for such dividends and making allowance for the dividends on the preferred and preference stocks, there should exist " 'consolidated earned surplus since December 31, 1937,' equal to the require-

---

[19] *Wall Street Journal*, May 15, 1939, p. 1.

[20] *Ibid.*

[21] *New York Times*, January 12, 1939, p. F1.

ments for six quarterly dividends on the preferred and preference stocks of the corporation."

2. The assent of the Commission was further dependent upon submission of the plan to the preferred and preference shareholders for their approval.[22] This requirement is particularly significant in that it grants voting rights to both the 5 per cent and the 6 per cent preferred stocks, which did not have such a prerogative when they were issued. In other words, the Commission saw fit to grant a privilege that did not previously exist as a legal right. By adoption of the plan, the company became free to pay dividends on the preferred stock without obtaining the specific approval of the Commission.

EFFECTS OF REGULATION

Such cases as the foregoing, and others too numerous to record in a volume of this type, reveal vividly the broad regulatory and supervisory power placed in the Commission. By its power to prescribe such "rules and regulations . . . as necessary or appropriate in the public interest or for the protection of investors or consumers" [Sec. 7 (*a*)], the Commission virtually holds the master key to the door of all financing by public-utility holding companies. Through its authority to approve specific issues, the Commission will in the end determine the character of the entire financial pattern. This will undoubtedly mean great simplification of the capital structure, and observers have commented that "the ideal corporate structure contemplated . . . appears to be one class of stock and one class of bonds."[23] The stock would have par value without preference as to dividends and would have at least equal voting rights with other securities [Sec. 7 (*c*) (1)]. The bonds would be of the mortgage type with a first lien on physical property [Sec. 7 (*c*) (1)].

The far-reaching consequences of such public control over private financial practice are readily apparent; and, similarly, it has been said that ". . . the act provides a basis for realigning the legal principles of corporate practice."[24] To a degree, there are a shifting and a modification of the fiduciary character which has been attached to officers and directors. Necessarily, the personal judgment of the latter must now give way before the decision of regulatory authority; and the responsibility of corporate officials, as a result, becomes limited in its scope. On the other hand, within the more limited area of responsibility, regulation must obviously establish checks and balances on private management which

---

[22] Common stock represented and voting in favor of the plan was more than 70 per cent; preferred stock, over 68 per cent; and preference stock, over 66⅔ per cent. There was less than three-fourths of one per cent of the shares of any class of stock which voted in the negative. See *Commercial and Financial Chronicle*, March 11, 1939, p. 1473.

[23] J. G. Meck, Jr., and W. L. Cary, "Regulation of Corporate Finance and Management under the Public Utility Holding Company Act of 1935," *Harvard Law Review*, Vol. LII (1938), pp. 216, 219.

[24] *Ibid.*, p. 216.

were not previously possible under a state of scattered stock ownership. Indeed, it may be said that "the Public Utility Holding Company Act of 1935 is the most ambitious statutory attempt yet made to deal with the problems resulting from the separation of control from ownership in the modern corporation."[25]

LIMITATION OF ACTIVITIES OF OFFICERS AND DIRECTORS

Throughout the act, an attempt is made to limit the activities of persons or of means that could conceivably be used to avoid its provisions or the regulations promulgated to secure its enforcement. For instance, solicitation and the use of proxies by "any person" may not occur except in conformance with prescribed rules. It will be recalled that this requirement is similar to that set forth in the Securities Exchange Act of 1934 (Sec. 14).

Undoubtedly, the motivating purpose underlying these limitations as well as others of the type is to curb various forms of "absentee control," with its possible sacrifice of operating welfare in favor of financial opportunities and manipulations. Because of this danger, it is not surprising that numerous restrictions have been placed on officials responsible for the formulation and direction of policy. Other provisions which serve to meet this end are the following:

1. Officers and directors must report their security holdings.
2. Similarly, these officials may not be directors or partners of investment banking houses.
3. Political contributions by holding companies are prohibited, and officers who appear before congressional bodies must register with the Commission.

OTHER RESTRICTIONS ON SALE OF SECURITIES

Brief reference may also be made to the numerous restrictions placed upon the methods of selling securities. To prevent sales campaigns enlisting purchases by employees and customers, which had been employed in earlier years, the law specifically forbids house-to-house selling as well as prohibiting sales through "any officer or employee of any subsidiary company" [Sec. 6 (*c*)]. Fees, commissions, or other forms of payment related to security issues must also be reasonable to permit qualification [Sec. 7 (*d*)]. Then, to prevent interlocking interests between registered holding companies and financial institutions (investment banks, trust companies, etc.), it is stipulated that the former shall not have as officers or directors any representatives of the latter [Sec. 17 (*c*)].

---

[25] *Illinois Law Review,* Vol. XXX (December, 1935), p. 509.

REORGANIZATION AND INTEGRATION OF UTILITY SYSTEMS

Possibly the most dramatic feature of the act is that which provides for the simplification of holding company systems. Preliminary to the final passage of the law, serious consideration was given to the complete elimination of holding companies in the public-utility field; but this failed to be enacted by a small margin. As now provided, it is the duty of the Commission to study the organization of every registered holding company to determine if it may be simplified in any way. More specifically, it is the Commission's duty to reduce all holding company systems to a well-integrated basis. The latter is defined as follows:

> As applied to electric utility companies, a system consisting of one or more units of generating plants and/or transmission lines and/or distributing facilities, whose utility assets, whether owned by one or more electric utility companies, are physically interconnected or capable of physical interconnection and which under normal conditions may be economically operated as a single interconnected and coordinated system confined in its operations to a single area or region, in one or more States, not so large as to impair (considering the state of the art and the area or region affected) the advantages of localized management, efficient operation, and the effectiveness of regulation.[26]

Exceptions to this requirement may be made only under the following conditions: (1) if operation as an independent system will result in the "loss of substantial economies"; (2) where the system may be located entirely within one state.

The creation of such integrated systems must obviously have considerable effect upon utility operations. The earlier public-utility organizations were developed on an opportunistic basis, with bargaining and financial design playing an important part. The act, however, is predicated on the theory that geographical unification is essential to sound management. For example, it would be contended that little could be gained in operating efficiency from common management of properties located, say, in Minnesota and Texas. There may be some divergence of opinion on this point as between the engineering and financial points of view; but, clearly, the most important and deciding factor must be that of public welfare.

THE DEATH SENTENCE

Section 11 (*b*) of the act is commonly known as the "death sentence," so called because of the requirement that all public-utility companies which do not fit into a "single integrated public-utility system" or which "unduly or unnecessarily complicate the structure" shall be dissolved or reorganized in accordance with the orders of the Commission. The con-

---

[26] Sec. 2 (20) (*A*). A similar definition is given for gas utility companies in Sec. 2 (29) (*B*).

stitutionality of this power was naturally challenged by the utility industry but was upheld by the Supreme Court in 1946.[27]

To visualize the sweep of required reorganization, we may note that "the maximum number of companies subject to the Act as components of registered holding companies at any one point of time was 1,620 in 1938." However, additional systems and companies became subject to the act, while others were being reorganized or liquidated; if the former are included, some 2,412 companies were subject to the act from June 15, 1938 to June 30, 1960.[28] During this same period, 2,070 companies have been released from the regulatory jurisdiction of the Securities and Exchange Commission or have been discontinued as separate corporate entities. Of these, 924 companies with assets of approximately $13,000,000,000 were divested by their previous parent organizations. As of June 30, 1960, there were only 13 solely holding companies and 6 holding-operating companies which were registered under the act; their aggregate, consolidated assets (less valuation reserves) as of December 31, 1959, were $11,529,548,147.[29]

In putting the program of simplification into effect, the Commission has been confronted with unique and complex problems of financial organization and policy. Management interests and the rights of security holders came under the scrutiny of the test of public welfare; and they have been the subject of great change. Significantly, one court declared that "the Act is a command of the government. Contractual relationship must . . . give slightly in the face of such legislation."[30] Basically, however, each plan of reorganization is subjected to two tests: (1) it must be appropriate to effect the provisions of Section 11, and (2) it must be "fair and equitable."

In distinguishing between reorganizations under bankruptcy and those brought about by the Public Utility Holding Company Act, it has been generally held that the latter represent a special form of action. As a result, the claims of the various security holders are deemed not to be matured and their treatment according to strict or absolute priority not warranted. In one case,[31] despite the fact that there were insufficient assets to cover the preferred stock and accumulated dividends, the common stockholders were allowed to participate. As stated by the court, "the test of fairness under the Act does not involve the application of a precise mathematical formula." Despite the earlier forecasts of doom and despair, the reorganization of a complicated utility system is now almost completed; and the net result gives promise of providing investors with a sounder corporate structure and consumers with an improved and more economical operating arrangement.

[27] *North American Co.* v. *Securities and Exchange Commission*, 90 L. Ed. 945.

[28] *Twenty-sixth Annual Report, op. cit.*, p. 132.

[29] *Ibid.*, p. 131.

[30] *In re United Light and Power Co.*, 51 F. Supp. 224.

[31] *Ibid.*, p. 223.

THE FUTURE OF HOLDING COMPANIES

The Public Utility Holding Company Act applies only to the public-utility industry, but its influence is not so limited. Rather, it stands as a signal to all financial interests that the public is concerned with the manner of their operation. Abuses in other fields could equally be the cause of extending the controls and restraints that grew out of the act. Nor is there any defense for the financial maneuvers which accompanied the promotion and development of holding companies of the type that appeared in the utility field. Actually, there are few advantages in the cumulative pyramiding of the corporate structure; and it leads to a complexity of organization which contributes little to the welfare of either the investor or the public. In short, it may be said that future financial policies will likely give even more consideration to public reaction, instead of relying so completely upon existing legal rights. As a result, it is probable that the use of holding companies will be limited to one or two levels in all fields of business operation.

QUESTIONS AND PROBLEMS

1. Evaluate the statement that public-utility holding companies were used in the twenties "not to build or improve utility properties but to purchase already outstanding securities . . ." Consider (*a*) the influence of the form of organization as such, and (*b*) the influence of the underlying motivation.
2. As stated on p. 592, "The holding company brings into focus the very penetrating question of the nature and purpose of a corporation." (*a*) Do you think that a corporation organized mainly for control purposes has economic or social justification? (*b*) Should the corporate form be used to facilitate personal conveniences?
3. Consider the possibilities of using the holding company for speculative purposes as distinguished from productive purposes.
4. Evaluate the financial merits and the public policy aspects of the Great Western case discussed on p. 593 of the text.
5. In your opinion, should there be a differentiation according to the separate fields of enterprise in the treatment of the holding company problem? In other words, if the holding company form is undesirable in the public-utility field, does it necessarily follow that it is undesirable in the industrial field?
6. Refer to Figures 2 and 3, and discuss the propriety of such organizations (*a*) from a legal point of view and (*b*) from a financial point of view.
7. What is a "great-grandfather" holding company? Discuss the effects of the remoteness of relationship.
8. In your opinion, is a holding company with nationwide interests engaged in interstate commerce? What is your definition of the term "commerce"?
9. One parent company received $26,000,000 in cash dividends over a period of years from an operating subsidiary company in which it did not have one penny of cash investment. Do you think this can be justified?
10. Compute the ratio of funded debt to total capitalization (*a*) for four operating utility companies of your choosing and (*b*) for four holding company systems.

11. What is your opinion of the financial status of debenture bonds of a holding company? (To be specific, it may be desirable to select a concrete case.)
12. "The record of the railroads is concrete evidence of the failure of government regulation of private business; at least a bad job has been done in setting up the financial structure. Similar results may be expected in the public utility field." Discuss.
13. "A much better check on private enterprise is found in the principle of the Securities Acts, which simply holds the responsible officials liable for misdeeds." What is your opinion of this view in comparison with the thought expressed in the preceding question?
14. Do you think the Securities and Exchange Commission was justified in refusing the Consumers Power Company the right to sell certain bonds?
15. Study the divestment of the holdings of any holding company of your choosing, and analyze the financial problems which were involved.
16. Evaluate the future of holding companies (*a*) in the public-utility field where they are used to integrate the operations in a clearly defined geographical area, and (*b*) in the industrial field as means of facilitating expansion by acquiring companies in similar or related areas of activity.

REFERENCES

ANDERSON, W. H. "Public Utility Holding Companies: The Death Sentence," *Journal of Land and Public Utility Economics*, Vol. XXIII, No. 3 (August, 1947), pp. 244 ff.

BONBRIGHT, J. C., and MEANS, G. C. *The Holding Company*. New York: McGraw-Hill Book Co., Inc., 1932.

BRADLEY, JOSEPH H. *Fundamentals of Corporation Finance*, chap. xxviii. New York: Rinehart & Co., Inc., 1959.

BURTCHETT, FLOYD F., and HICKS, CLIFFORD M. *Corporation Finance*, chap. xxxiv. 3d. ed. Lincoln, Nebraska: Johnsen Publishing Co., 1959.

DEWING, A. S. *Financial Policy of Corporations*, Book IV, chap. vi. New York: The Ronald Press Co., 1941.

DODD, E. M. "The Relative Rights of Preferred and Common Shareholders in Recapitalization Plans under the Holding Company Act," *Harvard Law Review*, Vol. LVII, No. 3 (January, 1944), pp. 295 ff.

ETHRIDGE, WILLIAM R. "Administrative Policy toward Security Issues under the Public Utility Holding Company Act," *Mississippi Law Journal*, Vol. XIII (1941), pp. 166–80.

GUTHMANN, H. G., and DOUGALL, H. E. *Corporate Financial Policy*, chap. xxvii. New York: Prentice-Hall, Inc., 1955.

JOME, HIRAM L. *Corporation Finance*, chap. xxix. New York: Henry Holt & Co., Inc., 1948.

MECK, J. G., JR., and CARY, W. L. "Regulation of Corporate Finance and Management under the Public Utility Holding Company Act of 1935," *Harvard Law Review*, Vol. LII (1938), pp. 216–58.

SECURITIES AND EXCHANGE COMMISSION. *Decisions and Reports*. Washington, D.C.: U.S. Government Printing Office, published serially.

SECURITIES AND EXCHANGE COMMISSION. *Annual Reports* (various years). Washington, D.C.: U.S. Government Printing Office.

Chapter 30 ►

FINANCIAL AND LEGAL ASPECTS OF MERGER

ATTENTION may now be given to the technical problems which are involved in merger. The conversion of separate corporate entities into a single concern sets into motion a long series of acts that are necessary to accomplish the transition. Not only are there numerous tasks of promotion, which include the selling of the idea and the determination of the means and ratios of exchange; but there are also many legal questions and arrangements which must be solved. In addition, it is of significance to consider the effects that merger may have upon the combined capital and debt structure.

PROMOTION—SELLING THE IDEA

The idea of merger, like that of all new business ventures, must be sold; this means that the parties who are to be affected must be convinced that something of value will be gained by the act of combining independent operations. It is true that merger tends to generate a sort of buoyancy that adds to its own salability; but, even so, there must be tangible proof of the savings to be effected. Experience shows that the results of combined operation are usually short of promised performance; but, despite this record, merger is popularly regarded as an elixir that works magic on business operations. Hence, when work sheets with figures revealing miraculous savings are produced, the promoters usually believe that they have a product that can be sold.

The task of promoting a merger does have the usual obstacles found in any barter transaction because it is essentially a trading proposition instead of a simple outright sale for cash. Existing security holders, or their representatives, must be shown something of value; and, usually, there is a discussion of the effects of merger in eliminating top executive positions. The latter point is frequently the most difficult problem to be solved by the promoter of the merger. Officers are usually influential people and may be important stockholders whose support would be help-

ful to the completion of the proposed organization. Yet the new concern will require only one set of officers, no matter how many constituent companies may be involved. In the merger of two companies, it is not uncommon for the top official of one company to become the chairman of the board of directors of the consolidated company and the other to become president. If five or six companies are involved, the problem will not be so simple. Suitable jobs must be found for the surplus officers, or they must be persuaded to retire from the scene before the merger may proceed. This takes time and may prove to be a costly as well as a delaying process.

Probably the first practical step in a move to bring about the merging of independent companies is to seek the co-operation and consent of the key interests. If this obstacle is hurdled successfully, the chances of overcoming the opposition of dissenting groups are much greater. Dissension may occur either because there is honest disagreement with merger as a plan of operation or because certain groups may wish to stage a tactical holdout for the purpose of securing a better trade. In either event, the promoters must move diplomatically to obtain the necessary degree of co-operation. On occasion, the promoters may choose to threaten exclusion or refuse to complete negotiations; in other instances, co-operation may be effected merely through friendly discussion and agreement.

There are no standard tactics; they vary according to the circumstances faced as well as the type of promoter. If the promoter is a professional, he will be familiar with numerous pitfalls which underlie the organization of a consolidated enterprise. If the promotion group consists of amateurs of the occasional-promotion variety, the way must be felt cautiously and carefully. The authors have had occasion to observe numerous promotions of small-scale mergers; and it may be said that the most serious obstacle is that of petty personal feelings and animosities. Patience and diplomacy on the part of the promoter are necessary to iron out these frictions, and it is always important to keep in mind the point of view of both sides. The burden of proof rests with the initiating party—the promoter; and the prospective members of the new company are likely to take advantage of this position by placing excessive values upon what they have to contribute.

THE VALUATION PROBLEM

One of the most difficult problems in the field of business is that of value determination, and the process of merger is no exception. Value is and always has been a vague and, at best, a relative concept. The pricing process involved in the exchange of goods results in a fleeting determination of relative values, but it is a determination whose definiteness disappears rapidly with time. So it is that seldom, if ever, do companies that are being considered for merging admit that the values carried on their

books are representative of their true condition. The books may show values at cost of some earlier date; or, in a few instances, they may show engineering appraisals. But the values are thought of only as being satisfactory for the use of annual and other financial statements and not for purposes of exchange or sale.

Moreover, not only is it a matter of the accuracy of the figures offered by the books; but also the mere existence of a sales opportunity results in a higher valuation in the mind of the seller and a lower one on the part of the prospective buyer. It is noteworthy how Mr. X changes the value of his plant when he is approached by a prospective buyer as compared to his reaction when he is simply reviewing the past operations of the enterprise or, better still, when he is discussing the value of the plant with the tax assessor. Indeed, it may be said in all seriousness that values are only estimates that are largely determined in the light of underlying purpose.

The valuation probably is so affected by the bargaining process that it is difficult to set forth any standardized rules for the establishment of values for purposes of merger. The various valuation formulas may be considered, but it must be kept clearly in mind that none of them yield results that are absolute or unquestionable.

BOOK VALUE AS A BASIS FOR MERGER

The inadequacy of book value as an expression of the financial status of a concern has been discussed in an earlier chapter on capitalization. It is equally deficient for purposes of merger. Not only does book value fail to register current values, but in addition it is deficient as a basis of comparison because of the nonuniformity of accounting methods employed by the different companies as well as the lack of consistency from year to year within a given company. Dissimilarities occur most frequently because of the following:

1. Dissimilar methods of charging depreciation. Just as depreciation has a pronounced effect upon the net earnings, it also automatically affects the book value of the asset being depreciated. The concern that follows the policy of charging liberal amounts of depreciation understates both its earnings and its asset values. In order to make a fair comparison of the values of two or more companies, the depreciation practices must be adjusted through the application of standard rates or uniform charges.
2. Lack of discrimination between expenses and capital expenditures. Some companies charge items of capital expenditure to expense accounts in order to understate earnings and to evade taxation partially. This policy is also followed by concerns to retain funds in the business without being under pressure from stockholders desiring larger dividends. In either case, the policy results in building hidden reserves and adds to the variance between book value and value for purposes of sale. Conversely, the charging of legitimate expense as a capital expenditure causes an overstatement in book values.

In addition to these conditions which account for discrepancies between companies, it should be pointed out that all companies intentionally ignore value changes growing out of broad market movements. Conservative accounting practice forbids the recognition of secular or cyclical appreciation in value and favors the use of cost as the ideal basis for accounting purposes. As a result, the concern that has made its capital outlays in the early stages of a major upswing in prices would have a lower book value in relation to present or actual value than would be true of a company whose capital investment had been made later at a higher price level.

APPRAISAL VALUE AS A BASIS FOR MERGER

Because of the shortcomings of book value, it is frequently suggested that the constituent properties be appraised. In an appraisal-value analysis, the property is broken down into its various component units for purposes of detailed examination. For the most part, an attempt is made to value the property at the prevailing replacement costs as estimated by competent engineering authorities. It is acknowledged that such a valuation has much significance as expert opinion, but the conclusions are not universally accepted. There is always the danger of variance in the findings of different appraisers, and the appraisal may not necessarily be substantiated by the earnings record of the properties. A concern that may cost a million dollars to reproduce will not be worth that sum unless it is able to earn whatever percentage of a million dollars the investment market may regard as desirable. And lastly, there is always the fact that markets are inclined to lay great stress upon their estimates of future possibilities, so that a concern with a high replacement or appraisal value and seemingly good earnings may have a poor bargaining position in the market because of actual or anticipated changing competitive and earnings conditions. For these reasons, appraisal value is only an important measure and not a final answer to the problem of valuation for the purpose of combining properties.

MARKET VALUE AS A BASIS FOR MERGER

The market value of a company may be defined as the amount that would be agreed upon between a willing buyer and a willing seller. However, corporations are not ordinarily sold in complete units; nor is it common to find the original stockholders or owners withdrawing as a group from participation in the combined concern. For this reason, the market value of a corporation is usually measured by the market price of its securities. This value is, of course, a highly fluctuating quantity. In fact, the fluctuation may be so violent and extreme that one might question the validity of using the market price of the securities as a basis for

exchange. Nevertheless, in spite of this shortcoming, it is given much consideration, primarily because of its wide acceptance. The public usually believes a stock is worth its market price, and any attempt to change this recognized label of value would encounter serious investor resistance.

It should be pointed out that the quoted market price is no indication of the value of an entire issue. The market has become exceedingly "thin" for many issues and can absorb only a few transactions without a substantial change in the quoted price resulting. This is even more true of the thousands of issues traded "over the counter." Most of such stocks are traded only intermittently; and the quotations would be subject to marked change in the event of even a minor change in supply of, or demand for, the stock.

Actually it is possible for stocks to be greatly overpriced in relation to normal values in periods of boom or prosperity psychology, as in 1929 and 1960. But to try to convince stockholders that they should accept less than the price set in the market would make failure of the combination project quite certain. For this reason, the ratio of the market prices of the securities involved in a proposed combination is given careful attention.

Granting the expediency of market prices as a means of determining exchange ratios, there is need to be aware of the influence of speculative activity. A rumor of impending merger may serve to increase greatly the activity in the trading of the stocks involved and be the cause of important changes in the relative market-price ratios. Also, it is quite probable that, prior to the advent of regulation by the Securities and Exchange Commission, insiders often manipulated prices to their own advantage.

One of the most serious shortcomings in the use of market price as a basis for exchanging securities is that the price itself is affected by early knowledge of the proposed action. Stock prices have a peculiar way of registering forthcoming events so that a part of the exchange ratio established may be the result of trading stimulated by the merger that is to take place.

Another defect in the use of market price as a basis for exchange of securities is the lack of uniformity in relation to the fundamental factors which underlie price. For example, the 1946 record shows that the stock of the General Motors Corporation sold on the average at a price equivalent to approximately 36.8 times its 1946 earnings. At the same time, the stock of the Chrysler Corporation sold at 17.5 times earnings; the stock of the Packard Motor Car Company at 28.4; and Nash-Kelvinator Corporation at 34.8 times earnings. Assuming a merger of the four companies at that time, would it be fair to base the exchange ratio of the stocks upon market prices? The difficulty of such comparisons may be emphasized by citing the record for 1950. In that year, the stock of the

General Motors Corporation sold, on the average, at 5.2 times annual earnings; that of the Chrysler Corporation, at 5 times earnings; that of the Packard Motor Car Company, at 12.2 times earnings; and that of the Nash-Kelvinator Corporation, at only 2.9 times earnings.

By 1955 we find a still different situation in the auto industry reflecting varying degrees of success or efforts to ward off impending failure. In that year, General Motors sold on the average for 9.5 times earnings and Chrysler for 7.2 times. Packard had merged with Studebaker and the combined firm was operating at a substantial loss. Nash-Kelvinator had merged with the Hudson Motor Car Company to create the American Motors Corporation which was also operating at a net loss per share. The stocks of the two "new" firms no longer had any true price-earnings ratio. In 1960, changed circumstances of the companies and in the securities markets resulted in the following average price-earnings ratios: General Motors, 13.2; Chrysler, 11.1; American Motors, 9.4; and Studebaker-Packard, 115.0. The last ratio was meaningless being the result of a 10 cent profit for the year. Such variations can only show the varying appraisals which the investing public gives to each company's prospects. Certainly, it is obvious that market price alone cannot fairly be used as the basis for merger.

Since the market value of the foregoing four automobile companies may not be related to earnings on a fair and equitable basis, consideration may next be given to book values as a basis for comparison. If the average market values of the securities for the year 1950 are related to book values for December 31, 1950, the following results are obtained:

Company	*Percentage of Average Market Price, 1950, to Book Value, December 31, 1950*
Chrysler Corp.	124
General Motors Corp.	212
Nash-Kelvinator Corp.	71
Packard Motor Car Co.	79

In 1955 and 1960, the ratios of average market price to book value at year end of these companies and their successors were as follows:

Company	*1955*	*1960*
Chrysler Corp.	112	70
General Motors Corp.	353	246
American Motors Corp.	32	193
Studebaker-Packard Corp.	67	152

It is apparent that there is a lack of uniform relationship between book and market values, and much difficulty would be encountered in determining an exchange ratio on this basis to effect a merger of these companies. Serious disputes would undoubtedly arise as to the validity of either the book or the market figures. Probably, in the event such a

merger were proposed, the discrepancies would be ironed out by the usual negotiation of promoters.

EFFECT OF MERGER ON SECURITY PRICES

The effect of merger on the security prices of the companies involved is difficult to analyze. Security prices in the stock market are made by a complex group of forces, among which might be mentioned the supply of and demand for the particular security, based largely on future prospects; the major bull or bear trend of the market; and the so-called "technical condition" of the market. Popularly, the announcement of a merger is regarded as being also an announcement of greater future profits. Hence, the supposition is frequently made that security prices will rise upon receipt of news of an impending merger. But such is not necessarily the case.

If the stock market should happen to be in a major bear or downward trend, news of the proposed merger might create little interest and have little effect on the stock prices. On the other hand, if the major price movement was bullish or upward, if there was a great deal of speculative enthusiasm, or if a "new era" was in sight, then the proposed merger would be likely to attract a large amount of interest, prices of the securities involved would rise, and stock sales would increase. In other words, the prevailing speculative psychology or the public fancy would seem to be controlling.

Of course, stock prices will be affected by the announced exchange ratio. If the announced price ratio differs from the market ratio, the latter will soon conform; but the price level at which this conformity takes place may change considerably. If the announced ratio is 3 to 1, the quoted prices can meet this ratio as well at $45 to $15 as at $30 to $10. The tendency will be to do so on the higher level if greatly increased earnings are expected.

Once the merger has been completed, the stock of the new company is subject to the same forces as any other stock. Prices will fluctuate with actual or expected earnings and will be subject to the usual broad market influences. The speculative influences due to guessing at the exchange ratios will be lacking, as will be the effect of anticipating profit gains arising from the new organization, since the actual results will soon become known. But all other market forces will remain.

Many of the stocks of the more successful mergers or combinations, such as the General Motors Corporation, United States Steel Corporation, E. I. du Pont de Nemours and Company, and International Harvester Company, are among the leaders of the stock market. As previously intimated, it is not believed that this is due to the mere fact of combination; rather, these organizations produce good products, which fact, when combined with good business conditions, makes it possible for them to

realize large returns. Any concern which makes profits, whether it is a combination or an independent, will be in demand in the market.

EARNINGS VALUE AS A BASIS FOR MERGER

It is a frequently quoted maxim that any commercial property or enterprise is worth what it will earn. Regardless of the cost of an investment, its present value can only be determined by its earnings. Certainly, no one buys property for business use unless the actual or anticipated earnings will support the investment to be made. The test of the wisdom of the investment, the ability of a company to meet competition, the desirability of its location, and the demand for a company's product may be expressed in concrete value terms only through the income realized.

At the same time, the answer is not as simple as it seems. There is the important question: Which earnings figure should be accepted as the criterion—gross earnings or net earnings? As a rule, the latter figure is favored, since it shows the amount that ultimately accrues to the benefit of the stockholders. On the other hand, net earnings do not allow for differences in management, which may constitute as strong a factor in determining earnings as the physical assets. Also, there is no assurance that salaries, depreciation expense, income from nonoperating sources, and similar items have been treated on a like basis.

Furthermore, the net income available for dividends would be affected by the capitalization. A concern having a large bonded indebtedness would show different results in so far as the common stock earnings were concerned than would a company having no bonded indebtedness. To correct this difference, it is possible to use net operating income before interest and similar financial charges as the basis for comparison; but such a transition would ignore the risks attached to long-term debt.

Comparison of net earnings is further affected by the number of shares outstanding. Some companies see fit to divide their stock into many shares, whereas others prefer to have fewer shares outstanding with correspondingly higher market values and per share earnings. For example, in 1960, General Motors Corporation's common stock was represented by 282,078,948 shares. Chrysler Corporation, on the other hand, had its common stock divided into 8,895,450 shares, or approximately 3 per cent as many shares as General Motors Corporation. Yet the Chrysler net sales in 1960 amounted to approximately 24 per cent of the General Motors sales; and the assets, as measured by balance sheet figures, were 17 per cent as large. It is impossible to measure precisely the effects of this stock structure on the market price; but, obviously, greater division will cause a reduction in the price which varies directly with the increase in the number of shares. If the division is sufficient to place the stock in a decidedly low price category, the added marketability tends to establish a

higher price in relation to the underlying factors than is true of stocks in higher price brackets.

More important than the earnings per share of any given year is the stability of earnings over a longer period of time. If they are fairly consistent from year to year, they may be accepted as arising out of efficient operation and sound organization. However, if they fluctuate widely without apparent or satisfactory explanation, they should be discounted as being due to fortuitous and nonrecurring circumstances.

PROPOSED BETHLEHEM STEEL AND YOUNGSTOWN SHEET AND TUBE MERGER

In order to make more concrete some of the principles of valuation presented thus far, brief consideration may be given to the attempted merger of the Bethlehem Steel Corporation and the Youngstown Sheet and Tube Company. Although the case is old, it is one of the compara-

TABLE 64

Comparison of Earnings of Bethlehem Steel Corporation and Youngstown Sheet and Tube Co., 1925–28*

Year	Bethlehem Steel Corp.		Youngstown Sheet & Tube Co.	
	Earnings Available for Common Stock	Earnings per Share on 1,800,000 Shares	Earnings Available for Common Stock	Earnings per Share on 1,200,000 Shares
1925	$10,172,541	$5.65	$12,331,180	$10.28
1926	14,069,892	7.82	14,349,762	11.96
1927	9,759,841	5.42	5,358,589	4.47
1928	13,378,664	7.43	9,768,100	8.14
Average:				
1925–26	12,121,216	6.73	13,340,371	11.12
1927–28	11,569,252	6.43	7,563,344	6.30
Four-year average (double weight given to 1927 and 1928)	11,753,240	6.53	9,489,053	7.91

* These figures are based upon the statement of Haskins and Sells; Lybrand, Ross Bros. and Montgomery; and Arthur Andersen and Company appearing in the *New York Times*, April 3, 1930, p. 45. The ensuing analyses are likewise based on this source.

tively few cases in which full details were made public. The publicity given the case resulted from a vigorous debate between interested groups of security holders following the announcement of the terms of the merger, some of the arguments being between outstanding public accounting firms which were employed in connection with the merger. Three outstanding firms were called to check the original findings, and

they concurred in the conclusions previously reached by the boards of directors. The statement of comparative earnings presented in Table 64 was submitted for the period 1925–28.

If we compare the weighted average earnings per share of the two companies, it will be seen that the stock of the Youngstown Sheet and Tube Company was worth 1.211 shares of the stock of the Bethlehem Steel Corporation. However, these figures do not include the earnings for 1929, which were treated separately due to the issuance of 1,400,000 additional shares of stock by the Bethlehem Steel Corporation for a consideration of approximately $136,000,000. Because of this, the adjustments shown in Table 65 were made to the income reported for 1929.

TABLE 65

ADJUSTMENT OF 1929 INCOME OF BETHLEHEM STEEL CORPORATION AND YOUNGSTOWN SHEET AND TUBE CO.

Income and Adjustments	Bethlehem Steel Corp.	Youngstown Sheet and Tube Co.
Earnings for common stock, as reported	$35,242,980	$20,739,174
Adjustments for insurance and excess tax provisions	2,283,191	268,596
	$37,526,171	$21,007,770
Less: Net earnings from new money included therein	1,746,533	....
Adjusted earnings exclusive of earnings on $136,000,000 of new capital of Bethlehem Steel Corporation	$35,779,638	$21,007,770
Saving on application of $86,000,000 to debt reduction	4,224,320	....
Adjusted 1929 income	$40,003,958	$21,007,770

At the same time, it was shown in the report that the Youngstown Sheet and Tube Company invested approximately $10,000,000 for additional finishing capacity at its Indiana Harbor plant, which did not become productive until 1930. It was estimated that on a 90 per cent operating basis, this plant would realize earnings of $2,200,000, which, added to the net income shown in Table 65, would give a total income for the Youngstown Sheet and Tube Company of approximately $23,200,000. This would mean (on the basis of the proposed exchange of 1⅓ shares of Bethlehem stock for 1 share of Youngstown Sheet and Tube)[1] that Bethlehem's earnings should be double Youngstown Sheet and Tube's, or

[1] The accounting firm employed by the opposition stated that a share of Youngstown Sheet and Tube Company stock was worth 1.79 shares of Bethlehem Steel Corporation stock—an excellent illustration of the difficulty found in agreeing on value. *New York Times*, August 6, 1930, p. 12.

equal to $46,400,000. This was determined through the following calculation:

To reduce the income to the same per share basis, it is necessary to multiply the net income of Sheet and Tube by 1½ (since Bethlehem Steel had 1½ times as many shares outstanding as Sheet and Tube), which gives a total of	$34,800,000
To this should be added ⅓ because Bethlehem offered 1⅓ shares for each share of Sheet and Tube	11,600,000
Total Bethlehem should earn in 1929	$46,400,000

Since the Bethlehem Steel Corporation actually earned approximately $40,000,000, there was a deficiency of $6,400,000. However, the accountants provided for this in the following words:

> To provide for this $6,400,000 Bethlehem will have available the earnings from, first, $50,000,000 of new capital, second, $25,000,000 of surplus earnings for 1929—a total of $75,000,000. To produce $6,400,000, this sum would be required to yield only about 8½ per cent, and if the conditions are assumed to be such that Sheet and Tube could earn 22 per cent on its new plant, it is reasonable to suppose that under like conditions Bethlehem's new plant would earn considerably more than 8½ per cent.

In view of these factors, the reporting accountants favored the exchange ratio of 1⅓ shares of Bethlehem stock for each share of Youngstown Sheet and Tube.

This established ratio of exchange is especially interesting in relation to the established book values of the respective stocks. On the basis of 3,200,000 shares (1,400,000 issued in 1929), the Bethlehem Steel Corporation had a book value of $142.69 per share. This figure is based upon the inclusion of insurance reserves as a part of surplus. On the basis of 1,600,000 shares (1⅓ times the 1,200,000 shares of Youngstown Sheet and Tube actually outstanding), the book value of the Youngstown Sheet and Tube Company was $80.04 per share. Furthermore, it was contended that this comparison was not entirely fair to the Bethlehem Steel Corporation, since it had included in its liabilities items not payable until later in 1930. If allowance were made for this, its unit book value would have been $144.74.

The contribution of net working capital of the two companies was, respectively, as follows:

Bethlehem Steel Corporation	$179,245,656
Youngstown Sheet and Tube Co.	74,898,139

After proper allowance for the greater number of shares Bethlehem had outstanding, the net working capital of Bethlehem was in excess of that of Youngstown; and, accordingly, the former company was in a more favorable position.

Review of the foregoing facts makes it plain that the major emphasis in this proposed merger was placed upon the relative earning capacity of the two companies. The greater nominal nature of book value was recog-

nized, but the significance of earnings was stressed. In particular, the more recent earnings of the two companies were given double the weight of the earnings for the previous two years. This is in line with a statement made earlier in this chapter to the effect that the trend of earnings must be given due consideration as well as the amount of earnings. At the same time, it is possible to overestimate the earnings of more recent years, as they may be more fortuitous than representative of normal conditions. Nevertheless, it is common to accept current values in preference to past values. But it should not be overlooked that a definite trend can be indicated only upon the basis of data covering an appreciable period of time.

Dissenting stockholders were successful in preventing the foregoing merger attempt. More than 25 years later another merger proposed by the two companies was set aside by anti-trust action of the federal government. Both companies had made several acquisitions during the intervening period. Bethlehem had purchased for stocks, bonds, or cash a number of small companies in such lines as bridges, barges, wire rope, and oil field goods. Youngstown's acquisitions had added to the basic tonnage capacity of that company. The government contended (and the court agreed) that a merger of the two companies would substantially lessen competition in violation of Section 7 of the Clayton Act.[2]

THE LIMA LOCOMOTIVE-GENERAL MACHINERY MERGER

In October, 1947, the Lima Locomotive Works and the General Machinery Corporation were merged to form a new organization known as the Lima-Hamilton Corporation. The case is interesting since it was technically an acquisition of assets rather than a merger. Moreover, it was the beginning of a series of mergers endeavoring to meet the changing economic circumstances of the industry but having dubious success.

The Lima Locomotive Works changed its name to Lima-Hamilton Corporation and increased its capitalization from 300,000 shares of no-par common to 3,000,000 shares of $5.00 par common. The outstanding common was exchanged in a ratio of 5⅜ shares of new common for each share of old stock. The Lima-Hamilton Corporation then purchased all the assets of the General Machinery Corporation for an amount of common stock equal to the outstanding number of shares of General Machinery common. Lima-Hamilton also assumed all the liabilities of the General Machinery Corporation. After this transfer of assets, General Machinery liquidated by distributing Lima-Hamilton stock to its stockholders on a share-for-share basis. The merger was accomplished on approximately a 10 to 7 basis, since the old Lima stockholders held 1,134,931 shares in the new corporation as compared to 805,952 shares held by the

[2] 168 *Fed. Suppl.* 576.

former stockholders of the General Machinery Corporation. However, the actual management of the continuing corporation appeared to be that of General Machinery.

The 10 to 7 ratio established in the merger gave greatest emphasis to the relative book values. The 10-year average earnings before provision for contingencies had been $1.04 per share of new Lima stock to $1.56 per share of General Machinery stock—or a ratio of approximately 6 to 9. The book value of Lima stock (after the split-up) was $15.61, while that of General Machinery was $12.86, a ratio of about 10 to 8. The adjusted market prices of the two stocks were approximately equal. Since, on the average, General Machinery's earnings had been more stable as well as higher, this merger would seem to have been unusually favorable to Lima stockholders. On the other hand, control passed to the General Machinery interests.

THE BALDWIN LOCOMOTIVE-LIMA-HAMILTON MERGER

On November 30, 1950, the Baldwin Locomotive Works acquired all the assets of the Lima-Hamilton Corporation through a share-for-share exchange of common stock. At the same time, the name was changed to the Baldwin-Lima-Hamilton Corporation.

Before making the exchange of stock, the Baldwin Locomotive Works distributed its security holdings to its stockholders by setting up a new securities affiliate, the Baldwin Securities Corporation. To this company was transferred most of Baldwin's holdings in the Midvale Company and the General Steel Castings Corporation, as well as cash from the sale of certain other securities. The stock of the Baldwin Securities Corporation was then distributed to Baldwin Locomotive Works stockholders as of record on November 29, 1950, the day before the stock was issued to Lima-Hamilton Corporation stockholders. In this way, Baldwin's stockholders received what amounted to a liquidating dividend prior to the acquisition of Lima-Hamilton.

During the two years following the formation of Lima-Hamilton, the company had earned an average of $1.52 per share per year and had paid average dividends of $0.615. At the end of 1949, the shares had a book value of $17.23. As of the same date, Baldwin Locomotive Works had a book value of $28.60 per common share, had two-year average earnings of $1.34, and had paid $1.00 per share in dividends. The securities transferred to the Baldwin Securities Corporation had been carried on the Baldwin Locomotive Works books at about $0.80 per share. The organization of the securities company had the effect of reducing Baldwin's book value to about $27.80. This left a book-value ratio between Baldwin and Lima of about 1.6 to 1 and an earnings ratio of about 1 to 1.15.

In view of the substantial difference in book values and the comparatively small difference in earnings, it would appear that Baldwin was

paying a premium to acquire the Lima-Hamilton operation. This is further supported by the market price of Baldwin stock, which had usually sold at higher prices than Lima-Hamilton stock. Baldwin's willingness to do so was probably caused by the company's policy of building an organization specializing in railroad and heavy industrial machinery, including earthmoving and roadbuilding machinery. Lima-Hamilton, as an important manufacturer of locomotives and power shovels, fits in this policy.

On March 18, 1951, as a further step in this policy, the Baldwin-Lima-Hamilton Corporation acquired all the stock of the Austin-Western Company. This was a small company manufacturing roadmaking, rock-crushing, and street-cleaning machinery, as well as dump cars. Its stock was acquired on the basis of 1.6 shares of Baldwin for one share of Austin-Western. Austin-Western had a book value of $18 per share and five-year average earnings of $1.70.

During the period 1952–60, the Baldwin-Lima-Hamilton Corporation acquired several small companies operating in machinery and equipment areas. It sold its Hamilton, Ohio, properties to Champion Paper Fibre Company and liquidated or dissolved all of its subsidiaries as separate corporate entities. The company's efforts to streamline its organization and diversify its product lines were not too successful. In the 1947–60 period, its sales increased only 8 per cent while the economy as a whole doubled. On the other hand, it did succeed in earning on the average over 4 per cent annually on net worth during that period. It is evident that its products lack any contra-cyclical effect.

AMERICAN METAL CLIMAX, INC.

This company was formed in December, 1957, as the result of a merger of the American Metal Co., Ltd. and the Climax Molybdenum Co. The merger took the form of the American Company buying Climax through an exchange of stock. The exchange ratio was three shares of American for one share of Climax. This ratio compared with the available data suggests that American must have seen some compelling reason for making the acquisition.

In 1956, American Metal's financial statements showed net tangible assets of $15.96 per share. It earned $3.49 per share in that year and paid dividends of $2.00 per share plus 5 per cent in stock. Climax, on the other hand, reported $24.97 as net tangible value per share, earnings of $5.87, and dividends of $3.60. The data taken by themselves suggest a ratio of about 1½ to 1 rather than 3 to 1.

CORN PRODUCTS COMPANY

The Corn Products Company is technically a new company, organized in September, 1958, to take over the business of the Corn Products Refin-

ing Company and Best Foods, Inc. Practically speaking, it was a device whereby the old Corn Products Company purchased Best Foods as part of its diversification program. The new company exchanged one share of its stock for each share of the Corn Products Refining Company and 1.6 shares for each share of Best Foods. The Corn Products Company thus paid 8,428,771 shares for the former refining company and 2,400,000 shares for Best Foods. It also issued $40,854,800 in 4⅝ per cent subordinated debentures and exchanged them for 233,456 shares of 7 per cent preferred of the old Refining Company on a basis of $175 par per share.

The exchange ratio of 1.6 shares of Corn Products common for one share of Best Foods was closely in line with financial relationships. In 1957, Corn Products Refining had reported net tangible assets of $19.51 and earnings of $2.52 per share. Best Foods had shown assets of $27.03 and earnings of $4.12 per share. Dividends had been $1.50 and $3.00 per share respectively. The exchange ratio was closely in line with earnings and slightly favorable to Best Foods in terms of assets. The new debentures substituted a tax deductible fixed charge of $1,890,000 for $1,634,000 "after tax" preferred dividends. This had the effect of raising net earnings per share by a few cents.

NATIONAL DISTILLERS—BRIDGEPORT BRASS

On June 30, 1961, Bridgeport Brass Co. was acquired by National Distillers and Chemical Corporation through exchange of stock. Bridgeport Brass lost its corporate identity and became an operating division under its old management. The merger represented a large step in National Distillers 10-year-old program of diversification into chemicals, fertilizers, plastics, rocket fuels, and rare metals. The Bridgeport organization gained stability by association with an expanding industrial complex and by reducing its dependence upon brass and tube mill products which have been problem areas for many years.

National paid 2,049,972 shares for the 1,518,498 shares of Bridgeport outstanding. This represented a ratio of 1.35 shares for one share of Bridgeport and would appear to result from an averaging of book figures. National had net tangible assets of $24.05 per share and earnings of $1.92. Bridgeport showed net tangible assets of $39.50 per share and earnings of $1.65 in 1960. Thus, Bridgeport's assets were 1.65 to 1 for National while earnings were about .86 to 1.

RIGHTS OF STOCKHOLDERS

Another important step in the process of merger is the approval by the stockholders of the various companies affected. Unless the question can be raised conveniently at the annual meeting, it is necessary to call a special meeting—a task of no small proportions in the case of companies

having widely scattered ownership. Of course, most of the votes cast would be by proxy; but, even so, it is not always easy to marshal a sufficient number to bring about an approval of the plan for the proposed merger.

It has been shown previously that merger usually results in the dissolution of the companies that are absorbed. The layman is likely to consider mainly the *de facto* aspects of corporate existence; but, in the eyes of the law, attention is also given to the *de jure* status.[3] The development of great freedom in the use of the corporate form has led to a general failure to appreciate its franchise aspects and the rights that exist as between the state and the corporation. Thus, under the basic law, corporations are not always free to dissolve, even with the unanimous consent of the shareholders.[4] It is contended that dissolution must likewise be approved by the government:

> Charters are in many respects compacts between the government and the corporators. And as the former cannot deprive the latter of their franchise in violation of the compact, so the latter cannot put an end to the compact without the consent of the former. It is equally obligatory on both parties. The surrender of a charter can only be made by some formal solemn act of the corporation; and it will be of no avail until accepted by the government. There must be the same agreement to dissolve, that there was to form the compact. It is the acceptance which gives efficacy to the surrender. The dissolution of a corporation, it is said, extinguishes all its debts. The power of dissolving itself by its own act, would be a dangerous power, and one which cannot be supposed to exist.[5]

At common law, the consolidation or merger of a private corporation requires the unanimous consent of the stockholders.[6] Consequently, the approval must be unanimous unless the state provides, by statute or by stipulations in the charters of the constituent corporations which are consolidating, for approval by a proportion less than the total of the stockholders. Modern corporation statutes do provide, however, for dissolution on the basis of less than unanimous consent and have likewise reduced the voting requirements for various extraordinary actions which may be fairly common to a number of corporations, although not repetitive in

[3] In order to have a *de jure* merger, it is necessary that there be a compliance with all statutory requirements, such as the giving of notice of stockholders' meetings, the filing of consolidation papers, the payment of fees, the giving of notice of the hearing on the application for consolidation, the election of the new board of directors, etc. (14A C.J., sec. 3646; *Ashley* v. *Ryan*, 153 U.S. 436; *Beardston Pearl Button Co.* v. *Oswald*, 130 Ill. A. 290).

[4] *Taylor* v. *Holmes*, 14 Fed. 498 (Off. 127 U.S. 489); *Beyer* v. *Woolpert*, 99 Minn. 475, 109 N.W. 1116; *Revere* v. *Boston Copper Co.*, 15 Pick. 351.

[5] *Boston Glass Manufacturing* v. *Langdon*, 24 Pick. (Mass.) 49, 53; Am. Dec. 292, Wormser's Cas. Corp., p. 454.

[6] *Ferguson* v. *Meredith*, 1 Wall. 25; 17 L. Ed. 604; *Gulf etc. R. Co.* v. *Newell*, 73 Tex. 334, 14A C.J. 1060; *Garrett* v. *Reid-Cushion Land and Cattle Co.*, 34 Ariz. 245; *Argenbright* v. *Phoenix Finance Corp.*, Del. Ch. 187 A. 183; *Mills* v. *Pennlox Co.*, 36 N.E. (2d) 828.

nature as to a single corporate body. As a result, a vote of 60 per cent, 66⅔ per cent, or 75 per cent is usually sufficient for purposes of approving mergers.

The legal status is also affected by the type of combination, i.e., whether it be effected by the creation of an entirely new corporation to absorb all participating companies or by an existing company which is used as a merging medium. Under the latter circumstances, there is the further question of the rights of stockholders of the company that is being expanded. One of the pre-emptive rights of shareholders is that of priority in the subscription for new shares which are issued—a point that is germane when the expanding company issues new shares to acquire the assets of the other corporations. Here, however, corporation statutes commonly restrict the pre-emptive rights of the shareholders to stock issues which are sold only for cash. The reason for this differentiation is one of practical necessity, a point that is presented succinctly in the following:

> The reason for the exception relative to issues for property, however, is practical necessity. Where the shares are to be issued for cash, the cash of one is as good as that of another. But the desired property is all held by a single person; he only can transfer it to the corporation. Usually it is not feasible to issue the shares for cash and then to use such cash to acquire the property, since the prospective shareholder will probably have stipulated that the property must be exchanged directly for shares. Unless the shares can be so issued direct, the property often cannot be acquired.[7]

TREATMENT OF MINORITY STOCKHOLDERS

It is seldom possible to secure 100 per cent approval for a merger program, so the question appropriately arises as to the rights of the minority under such circumstances. Stockholders may not be coerced into a new organization, and those who object may do so upon the basis of the illegality of the proposed merger or upon its economic inexpediency. Thus, a dissenting stockholder may complain when the merger is believed to be *ultra vires;* this may be the case even though the merger is advantageous. Gross overvaluation or undervaluation of a constituent corporation is likewise grounds for complaint on the part of the dissenting stockholder. In some states, mergers are not legal unless the new company is in the same line of business as the original concern.[8] In this event, a stockholder may prevent the officers or directors from taking the corporation into a field of business in which he did not intend to invest his funds. On the other hand, it may be that the stockholder deems the proposed merger an unwise move which he wishes to prevent for his own

[7] Henry S. Drinker, "The Pre-emptive Rights of Shareholders to Subscribe to New Shares," *Harvard Law Review*, Vol. XLIII, pp. 586, 607.

[8] *Cameron* v. *N.Y. etc. Water Co.*, 62 Hun. 269, 62 N.Y.S. 757; *Copeland* v. *United Shoe Mach. Co.*, 84 N.J. Eq. 276.

interest. In either case, he has recourse to a court of equity and an injunction process.

As a result of legal proceedings, the company may be compelled to settle with the minority on some basis as determined by independent appraisers;[9] or the court may hold the proposed merger illegal and enjoin it.[10] The latter procedure was followed in the case of the proposed Bethlehem Steel and Youngstown Sheet and Tube merger. If the number of objectors is not large and the amount of their holdings is not excessive, the usual procedure will be for the merged company to buy up their holdings. Sometimes, excessive prices are paid because of the minority's nuisance value and ability to hinder the merger through court proceedings.

The unanimous consent of the stockholders is not required in the carrying-out of the charter powers of a corporation if it is done in good faith and without fraud.[11] Normally, minority interests are automatically subject to the will of the majority; but the act of merger is deemed to be extraordinary in character. To illustrate the difference, minority stockholders may oppose the sale of securities having priority; but there is nothing they can do about it if the transaction is made in good faith. However, this is an act that is entirely within the existing corporate structure; whereas consolidation means its complete elimination. Hence, special recognition is given to the plight of the minority position; it may not be used to obstruct consolidation, but neither may the dissenting stockholders be compelled to acquiesce.

TREATMENT OF CREDITORS

Not only is it impossible to ignore the rights of the minority stockholders; but it also is necessary to give careful consideration to the rights of the creditors, both secured and unsecured. However, the consent of the creditors is not necessary in order to effectuate a merger.[12] The exact status of the creditors is, to a great extent, determined by the form of combination. If it is brought about by the use of the holding company device, the creditors may look only to the subsidiary corporation against which the claim originally applied. The creation of the holding company does not in any way destroy the entity of the subsidiary company; therefore, there is no problem in adjusting the position of the creditors unless

---

[9] *Chicago Corp.* v. *Munds*, 20 Del. Ch. 142, 174 A. 452; *Ahlevius* v. *Bunn & Humphreys, Inc.*, 358 Ill. 155, 192 N.E. 824; *American General Corp.* v. *Camp*, 171 Md. 624, 190 A. 225.

[10] *Alpren* v. *Consolidated Edison Co.*, 168 Misc. 381, 5 N.Y.S. (2d) 1254; *Anderson* v. *Int. Min. & Chemical Co.*, 295 N.Y. 343, 67 N.E. (2d) 573; *Perkins* v. *New Hampshire Power Co.*, 90 N.H. 534, 13 A (2d) 475; *Salt Dome Oil Corp.* v. *Schenk*, 41 A. (2d) 583.

[11] *Sabre* v. *United Tract, etc. Co.*, 225 Fed. 601.

[12] *Cole* v. *Nat. Cash Credit Ass'n.*, 156 Atl. 183.

by chance the creditors had a specific provision in their contract which limited the company in taking part in any form of combination.

When the separate corporate entities are destroyed, the creditors must necessarily look to the merged company for settlement. In general, it may be said that a merged corporation may be held liable for the liabilities and obligations of the constituent corporations.[13] This is the case whether such liabilities and obligations arise out of contract or out of tort. Such responsibilities of the merged corporation may result from the imposition of the same by statute, or they may arise out of the consolidation agreement or charter.[14] Under these circumstances, it may be difficult to maintain the exact identities of the various claims originally held against the constituent companies. Secured claims and liens are not affected to any great extent because the merger in no way affects the character of the lien on the acquired properties. Moreover, any later mortgage placed on these properties by the merged company must clearly be junior to the liens already of record.

Provision for protecting the interests of general creditors is generally made either in the merger agreement or by the statute under which the attempt to effectuate the merger is being made. General creditors have no claims as such against the assets of the constituent corporation. If it is necessary to enforce claims by legal proceeding, the general creditors may go into equity and either follow the assets of the merging company or proceed against any other property of the enlarged corporation to satisfy a judgment. An action at law is also available to creditors against the consolidated corporation for the unpaid obligations of the merged corporations. When such property has fallen into the hands of a bona fide purchaser for value, the general creditors would be unable to follow the assets for the purpose of satisfying their claims.[15]

Conceivably, there may be some change in the quality of the general credit position of the merged company as compared with that of the constituent companies. The credit ratings of the companies taking part are not likely to be identical, and the merger of the different companies could affect the security of the claims of the general creditors. However, there is little likelihood of trouble developing from this source because of the preferred position of debt. Indeed, if it could be shown that merger made the position of the general creditors precarious, there would be grounds for legal action. Hence, the unsecured creditors usually look to the newly organized company for payment and share on a parity with any new unsecured creditors who make their appearance in doing business with the merged company.

[13] *Atlantic and B. Ry. Co.* v. *Johnson*, 127 Ga. 392, 56 S.E. 482.

[14] *McWilliams* v. *New York*, 134 Fed. 1015; *State* v. *Baltimore, etc. R. Co.*, 77 Md. 489.

[15] *McMahan* v. *Morrison*, 16 Ind. 172.

PSYCHOLOGICAL AND OTHER EFFECTS OF INCREASED SIZE

Attention has been directed thus far mainly to the transitory elements which enter the process of effecting a merger. During this period, there are also anticipation and planning with respect to the consolidated structure as a whole. Particularly is this true with respect to the financial pattern which must necessarily be evolved both to accommodate the demands arising from the absorption of the other companies and to carry the consolidation itself as a going concern in the future.

Undoubtedly, large corporations tend to create a psychological complex of size and great power. There is a feeling of enlarged financial outlet and a belief that new facilities of financing are available. To a degree, this is true, although the net result may be more quantitative than qualitative. It is for this reason that it is exceedingly difficult and hazardous to evaluate the relative merits of different sizes. The element of size does give added force and power to a business in the same way that individuals of great wealth have numerous advantages not possessed by those of lesser means. The ratios between assets and liabilities may be similar or may even be in favor of the latter group, but this in no way lessens the greater opportunities arising from bigness alone. To be specific, an individual with assets of $15,000 and liabilities of $5,000 may be relatively as well off as one with assets of $15,000,000 and debts of $5,000,000, but his net position is weaker. He cannot do as much with his differential of $10,000 as the more wealthy person with $10,000,000 of free assets at his command. So it may be with corporations whose net asset position is enlarged by virtue of consolidation or merger.

POSSIBILITIES OF CHANGE IN CAPITAL AND DEBT STRUCTURE

There is considerable evidence that size may have an effect upon the financial pattern. There are many reasons why larger companies have a greater proportion of funded debt in their capital structure, but there can be little dissent from the view that size is one of the factors. As we have shown on previous occasions, larger companies undoubtedly have greater access to money markets than smaller concerns. It should be emphasized that the large companies frequently do not take advantage of this greater opportunity to resort to funded debt, but this is mainly the result of deliberate policy rather than lack of opportunity.

A review of past mergers and combinations shows the expected variety of results. Some immediately resort to the use of funded debt; others make little change from the prevailing types of securities found in the constituent companies; and there are instances where funded debt has been eliminated. For the sake of illustration: bonds played a prominent part in the initial financing of the United States Steel Corporation; but the merger of the Dodge Brothers Corporation into the Chrysler Corporation

brought about the retirement of the bonded indebtedness of the former within seven years. The National Dairy Products Corporation, which has pursued a policy of combination over a long period of years, has made the use of bonds a regular part of its financial program.

It cannot be said with certainty that merger per se causes the use of funded debt, but it may be reasonably granted that the enlargement of operations arising from merger does facilitate its use. Actual resort to the use of bonds will always depend upon specific policy and will likewise be effected by such other factors as the need for additional capital, the relative cost of different forms of financing, the state of business conditions, etc. With allowance for such variables as these, it may be said that merger as a form of organization does tend to exert influence as a financial factor.

The qualitative results of merged operation as compared with those of independent operation are difficult to evaluate. This has been shown in a previous chapter and needs only to be reiterated here. Some mergers have achieved signal success; others have failed miserably. The financial side probably assumes undue proportions because of its spectacular character and because it is the means of giving expression to the changes that occur. In the end, however, large-scale merger will be judged in the light of the larger, ultimate objectives. Such conditions as the centralization of business authority, the concentration of industry, and numerous other social aspects may be expected to exert the usual inexorable pressures of long-term development.

QUESTIONS AND PROBLEMS

1. What effect does merger normally have upon the number of employees? Do you believe that special consideration should be given to the top jobs as distinguished from ordinary positions?
2. "Plain horsetrading and bargaining are more important as means of establishing values for combination purposes than all the more scientific approaches." Discuss.
3. "Market value is particularly deficient as a basis of establishing exchange ratios because the market price itself is affected by the act of merger." Discuss.
4. Show the importance of earnings as a factor in determining valuation, but also indicate some of the problems that arise in comparing the earnings of different companies.
5. Analyze the comparative positions of the Bethlehem Steel Corporation and the Youngstown Sheet and Tube Company, and indicate what you think would have been a fair ratio for the exchange of stock had the 1956 merger been permitted.
6. Analvze the merger of the Nash Motors Company and the Kelvinator Corporation; and state your opinion with reference to the desirability of this merger, its purpose, the results achieved, the fairness of the exchange ratios, etc.
7. Do you believe that formal vote by the stockholders upon the question of

merger is particularly significant? Would you favor giving full power to the board of directors to consolidate without action by the stockholders?

8. Do you believe that minority stockholders should be compelled to participate in a merger? (It is desirable to present the arguments on both sides of this question.)
9. Investigate the financial basis of a recent "conglomerate" merger. (See Chapter 28 for examples.)
10. Supporting its proposed taking-over of the Barnsdall Oil Company, the Sunray Oil Corporation stated that the merger would provide "proved reserves of natural gas of 1,298,000 million cubic feet. . . ." The proxy statement also revealed that the underwriting firm "will receive between $1,300,000 and $1,800,000 for its services in arranging and aiding the financing of the merger of these two companies." (See *Wall Street Journal*, May 12, 1950, p. 9.) Discuss the merits of this merger and the part that investment bankers play in bringing about such actions.
11. Analyze the factors in arriving at the exchange ratio for merging American Metals and Climax Molybdenum. What has been the subsequent success of the merged company?
12. Evaluate the NAFI Corporation and Chris-Craft Corporation deal in early 1960?
13. What financial problems are implicit in such actions as Brunswick's acquisition of a boat company or American Machine and Foundry's purchase of a sporting goods manufacturer?

REFERENCES

BURTCHETT, FLOYD F., and HICKS, CLIFFORD M. *Corporation Finance*, chap. xxxii. 3d ed. Lincoln, Nebraska: Johnsen Publishing Co., 1959.

GERSTENBERG, CHARLES. *Financial Organization and Management*, chap. xxiii. 4th rev. ed. Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1959.

KOLTKE, FRANK J. "Mergers of Large Manufacturing Companies, 1951–59," *Review of Economics and Statistics*, Vol. XLI, No. 4 (Nov., 1959), p. 430 ff.

NATIONAL INDUSTRIAL CONFERENCE BOARD. *Mergers and the Law.* New York, 1929.

"Rights and Remedies of Dissenting Stockholders upon Consolidation and Merger," *Michigan Law Review*, Vol. XXXII, No. 8 (June, 1934), pp. 1074–87.

PART VII ►

Failure and Reorganization

Chapter 31 ►

FAILURE—CAUSES AND CONSEQUENCES

THE DISINTEGRATION of a business, with subsequent repair or junking, represents a less happy phase of business life. The evidence of the disintegration appears when the business fails to show an adequate profit to its owners. It probably started, however, many months or years prior to this time. The causes are numerous, although they fall readily into two broad classes: (1) internal and (2) external; that is, those which have to do with the quality of the management and those which come from outside the individual business. Before considering these causes, however, it will be helpful to define the problem of failure and consider its significance in the economy as a whole.

DEFINITION OF FAILURE

In its broad sense, failure is the opposite of success. In the business world, however, the term is generally reserved for a certain degree of lack of success and the official recognition of it. We may say that a business is not successful when it fails to earn a profit, but we do not use the term "failure" until conditions become such that management cannot or will not pay debts when due or decides to close its doors. When such conditions are encountered, the business is a failure. Since creditors may voluntarily waive claims when due, some persons wisely reserve the use of the term "failure" to the time of official declaration of bankruptcy.

One should bear in mind that a business may operate for a considerable period under conditions associated with failure and be commonly identified as such, just as a student may be doing unsatisfactory work in a course for some time prior to the issuance of the official failure grade. Even though all the creditors of a business may be satisfied, the owners of the business may conclude that their investment is not earning an adequate return. As a result, they may liquidate the business, in which case it is perfectly appropriate to refer to the business as a failure. However,

the sale of a business as a going concern, possibly even at a substantial loss, does not constitute a business failure, unless there were bankruptcy proceedings involved.

WHY STUDY BUSINESS FAILURES?

The path to business success is not an easy one; and, as a result, failures of business firms are common. Although we are primarily interested in the financial aspects of the going concern, there is much to be learned by studying business failures. First, we may identify the causes of business failures and the obstacles to financial success; second, we may investigate the means of avoiding or preventing these causes and obstacles; and, finally, we may see how firms actually reorganize after failure.

It should be stressed that the emphasis in this chapter is upon the phenomena leading to financial distress or failure and not upon the state of failure as such. Viewed from this angle, the discussion should be equally pertinent to the operation of a solvent, going firm.

ECONOMIC SIGNIFICANCE OF FAILURES

The failure of a business firm is a misfortune to its owners, creditors, employees, and even customers. Investors place their funds in a business with the expectation that the value of the funds will not only be preserved, but enhanced. A business failure destroys these expectations. The ultimate result may be a partial or complete loss of values invested. Because of their priority of claims, creditors are less likely to lose part or all of their investments than are the owners. Nevertheless, the result may be losses to creditors; and, certainly, there will be many inconveniences. As for employees, business failure results in the loss of jobs. Even before the actual failure, financial distress may lead to layoffs or may slow the payment of wages. Managerial employees are particularly concerned with a business failure, since they are the ones who are hired by the company to guide it and to make it function with a profit to its owners. Customers, too, have a stake, since a closed business may shut off a source of supply which had been counted upon. New, and possibly inferior, sources may have to be sought out if even one business ceases operations.

About the only consolation of a business failure to those directly involved is that it marks the beginning of what can be an orderly, legal process to bring the difficulty to a close. Investors suffering loss can at least look forward to the certainty of realistic accounting instead of having their funds tied up without return or accurate evaluation for an extended period of time. Creditors can look forward to a settlement with the ground rules clearly defined.

From the point of view of the economy as a whole, business failures are generally an economic loss. Many of them could be avoided by the

adoption of different policies by individuals directly associated with the firms or by timely and well-guided group action. The economist is always concerned with ways and means of avoiding failures. He knows, however, that some businesses are destined to failure at the time they are being organized and that others are bound to fail unless ownership-management is changed before it is too late. To the extent that the management of individual businesses is not qualified and will not relinquish control, failure is inevitable; and the sooner the break comes, the better it is for all concerned.

Economic conditions have generally been such that business failures have been of little direct social importance as a national problem. In the early 1930's, however, business failures became so prevalent that they were a problem of national significance. At that time, failures occured on such a large scale that the standard of living was jeopardized, both for those immediately concerned and for the community as a whole. The foundations of social law and order were shaken. Unemployment became so widespread that great segments of our population were unable to earn a living at private employment. The closing of banks stifled the flow of money and credit which is essential to the conduct of business. The distress of this period led to drastic measures for relief by the federal government. The Home Owners' Loan Corporation was organized to refinance distressed home owners, and the Reconstruction Finance Corporation came to the rescue of financial and business institutions. The Work Projects Administration and predecessor organizations provided work relief for employees. The governmental lending agencies did not attempt to prevent all liquidations. Instead, the liquidation of concerns in an incurable state was facilitated. At the same time, loans and other assistance were extended to institutions that were deemed to be sound and that had reasonable prospects of recovery.

Under normal circumstances, an undetermined amount of business failure must be thought of as part of the price paid for an active, dynamic, and relatively free economy. A high degree of freedom of access to business activity carries with it freedom to "retire" from business. This retirement may be voluntary, i.e., due to a lack of success, or it may be compulsory, i.e., failure. In either event, business turnover is necessary to our system. While it can be reduced through the study of management methods and the development of economic stability, it is not likely that it can be avoided completely.

EXTENT OF BUSINESS FAILURES

The U.S. Department of Commerce has for the past several years prepared official estimates of the "business population," that is, the number of business firms in operation in the United States. As a part of this statistical series, it estimates the number of new businesses created, the number

of businesses for which ownership has been transferred, and the number of "discontinuances" of businesses. Since it is statistically difficult, if not impossible, to distinguish between discontinuance resulting from failure and discontinuance resulting from other causes, the statistics do not show the separation. The presumption is that a high proportion of discontinuances, however, result from failure. Data for new and discontinued and transferred businesses are given in Table 1 (p. 42). Figures for the estimated number of businesses in operation each year, 1940–60, are given in Table 66.

TABLE 66

BUSINESS POPULATION ESTIMATES, 1940–60*

(In Thousands)

Year	*Estimated Number of Firms*†
1940	3,290.8
1941	3,269.6
1942	3,185.8
1943	2,905.1
1944	2,916.5
1945	3,113.9
1946	3,487.2
1947	3,783.2
1948	3,948.4
1949	4,000.0
1950	4,050.7
1951	4,108.5
1952	4,167.4
1953	4,193.9
1954	4,189.0
1955	4,286.8
1956	4,381.2
1957	4,470.7
1958	4,534.4
1959	4,583.0
1960	4,660.0

* *Survey of Current Business.*

† The 1940–58 data are annual averages of monthly figures; 1959–60 data represent year end estimates.

Statistics for the past decades reveal some of the relationships which may be expected between business population and the several phases of the business cycle. Barring the need for major readjustments necessitated by a war or some other phenomenon, discontinuances normally are less numerous in periods of the upswing and crest of the business cycle. On the downswing and trough of the cycle, they become important. Firms that can easily remain solvent during periods of increasingly high business activity frequently cannot adjust themselves to any slackening in activity, and failure results. During such periods, the fall of one

important firm may lead to the fall of many related firms closely tied to it financially or associated with it as suppliers or distributors. The wave of failures in the early thirties was associated with the severe depression of that period.

A private organization, Dun & Bradstreet, Inc., has for many years prepared statistics on business failures. These data are broken down in considerable detail and are extensively cited in the press and in textbooks. Dun & Bradstreet limits failures to bankruptcies. This practice makes for a clean-cut statistical definition but results in the exclusion of the large number of failures which do not end in bankruptcies.

CAUSES OF FAILURE

It is not easy to isolate with exactness the cause or causes of failure in any individual case. Frequently, a whole series of contributing circumstances lead up to the single event which immediately and directly brings on a failure. Any one of these circumstances, such as unsatisfactory labor relations, might not be sufficiently important to bring about a failure; but, when combined with poor advertising policy, collapse of a market, or other factors, the result can be disastrous. Thus, it is important to consider business failures from the point of view of "fundamental" causes as well as the ways the causes may be evidenced. See Table 67, which is based on data prepared by Dun & Bradstreet, Inc.

TABLE 67

WHY BUSINESSES FAIL

(Year Ended December 31, 1960)*

Fundamental Causes		*Per Cent of Total Evidencing Cause*
Inexperience and incompetence		90.8
Evidenced by:†		
Inadequate sales	48.8	
Heavy operating expenses	5.7	
Receivables difficulties	8.9	
Inventory difficulties	7.0	
Excessive fixed assets	6.6	
Poor location	2.3	
Competitive weakness	23.0	
Other	4.2	
Neglect		3.2
Fraud		1.7
Disaster		1.1
Reason unknown		3.2
Total		100.0

* *Dun's Review and Modern Industry,* March, 1961, p. 3. Based on opinions of creditors and information in credit reports.

† Since some failures are attributed to a combination of causes, percentages do not add up to 100 per cent.

IMPORTANCE OF HUMAN ELEMENT IN BUSINESS FAILURE

One glance at Table 67 indicates the importance of the human element in business failure. It also shows how failure is dependent primarily, if not almost entirely, upon the degree of competence and experience of management. While the most recent data do not distinguish between incompetence and inexperience, earlier studies showed that over 40 per cent of the failures was primarily attributed to incompetence—management that the creditors felt was not and presumably could not be trained to operate successfully. Another 40 per cent of the failure was attributed to the lack of management experience—experience in the particular industry or trade—or lack of experience in certain functional phases of the management of a business. Presumably, these managers were capable of learning how to manage their business successfully but failed to do so prior to the time they failed.

Although incompetent management is the most important single cause of failure, it may not always have such a drastic consequence. Concerns may, despite poor leadership, survive for years because of favorable environments or some peculiar skill. When sellers' markets and rising prices are prevailing, ability to get merchandise or raw materials may be the only requisite for obtaining a passing grade for the management. Poor cost control, bad personnel relations, and inadequate financing may not make themselves felt. But let normal competitive markets reappear and such concerns will disappear in large numbers. Or again, the management which fails to insure against normal casualty risks, such as fire, explosion, or employee fraud, may enjoy prosperity for years before a serious fire or fraud demonstrates the inadequacy of the management's policies. In other words, incompetency alone does not necessarily result in failure. Probably, in most instances, failure is caused by a convergence of several factors. Besides incompetence of management, there are other deteriorating influences: shrinking markets, prolonged labor strikes, and various external events too numerous to mention. The student should, in making an analysis of failures attributed to incompetent management, investigate what management did or neglected to do. Attention may now be given to the more commonly recognized conditions which contribute to failure.

INFERIOR PRODUCT OR SERVICE

Attempts to produce and sell inferior products have led many business firms to failure, or to the brink of it, prior to the correction of the situation. Inferiority of product may exist from the time of initial introduction or, as is more commonly the case, may develop because of a lowering of quality or because of failure to keep pace with technical improvements of competitors. The preventive for this type of obstacle to success

is obvious—improvement or change of product. However, the application of the preventive may be difficult, if not impossible. The company may have developed such an unfavorable reputation that consumer resistance cannot be overcome with a change of product. Also, the facilities of the manufacturing concern may be such that it is impossible to convert to the production of an improved or different product.

Failures resulting from the attempt to produce and sell inferior products are most likely to occur among small enterprises introducing new products which do not have an established demand. Immediately following World War II, many firms introduced new products with only a vague knowledge of the extent of consumer demand for the products and still less understanding of what qualities customers would expect in the products. Dozens of companies introduced deep-freeze refrigerators for home use. Some of them were of poor design and not satisfactory in operation. The market would not take them, and the undertakings failed. Similar experiences have been suffered by some producers of plastic articles and radios. This type of obstacle to success is, in part, inherent in industry, since only by actual trial are consumer demands made known. However, much could be done to lessen the risks by careful analysis of the market prior to the introduction of new products. Before introducing any new product, the major electrical appliance producers make a careful investigation of the need for the proposed product and an analysis of the desirable qualities to incorporate.

Gradual lowering of qualitiy in a nationally known product has caused difficulty for many concerns. It is not infrequent that a producer of a product having wide consumer acceptance believes the public will not realize the product has been cheapened. Several years ago, one of the small automobile tire producers had built up an enviable reputation for a high-quality product. The company changed hands and the new management attempted to produce an inferior tire, yet sell it as a quality product on the reputation built up by the predessor. The buying public was not to be fooled for long, and the reputation for quality died quickly, as did the competitive advantage that this small producer had.

More common than the above-mentioned obstacles to success are those associated with technical changes in products introduced by competitors. One of the classsic examples is that of the Model T Ford, which had been the stand-by of low-income families for so many years. Competing companies, desiring to capture some of the Ford market, introduced a series of radical innovations over a period of a few years. These improvements were so acceptable to the buying public that the Model T was doomed. Fortunately for the Ford Motor Company, the production facilities for automobile manufacture are flexible enough to permit the manufacture of a completely redesigned product. Instead of going on the rocks, the company introduced the Model A, which promptly recaptured much of the lost market.

Technical changes have proved more serious in some other fields. At one time the electric interurban was very popular, but the advent of high-power, private automobiles and all-weather highways spelled their doom in all but a few localities. Thousands of miles of railroad tracks have been abandoned because of motor truck and private passenger vehicle competition. Railroad pickup and delivery service, fast freight trains, and luxury passenger travel have been tried by some railroads to offset these developments. However, many short-line roads have had to dissolve because of this new competition. Today there is speculation as to whether television will have a permanent effect on the movie industry.

In the merchandising field, the development of self-service chain supermarkets represents a new type of service to buyers that is lower in cost than the old methods of distribution of groceries. The result has been numerous failures among independent grocers. Some have survived by introducing cost-saving methods or by rendering new special services.

IMPROPER PRICING

Proper pricing is essential to business success. Prices that are too low may bring volume, but they will not cover costs and provide a profit. On the other hand, prices that are too high may cover costs but fail to bring sales because of competition. The theory of pricing and its application in business is complex and certainly impossible of even modest treatment in a textbook on corporate finance.

The bases of adequate pricing are complete costs records and a knowledge of competitive prices, not only for the same product but also for other products which may be used as substitutes or alternatives. Management cannot be excused for improper pricing that causes a failure. New, small producers frequently have difficulty with pricing because they do not take into consideration the costs of marketing. Retail merchants, who should be keenly aware of the dangers of loss of business due to overpricing in a competitive market, often believe they can put prices above the market on the basis of special services, such as delivery, assurance of quality or a liberal return policy. To be successful, however, the merchant actually has to render these services, not just profess to, and has to know just how much his customers will pay as a premium for them.

The obstacle to success resulting from improper pricing is not to be confused with failures resulting from excessive costs. With excessive costs, no price policy can bring success.

EXCESSIVE COSTS

From the point of view of management, excessive costs are of two types. The first type is excessive costs which are not subject to correction.

They are excessive in the sense that other producers, operating at less cost, can satisfy the market. Firms with this type of excessive costs are eventually doomed. The second are those excessive costs which are subject to correction by management through savings in producing the same product or through change of product.

Amortization of bonded indebtedness and high fixed overhead expenses, particularly burdensome interest charges, were the cause of difficulties for many companies in the thirties. These excessive costs, incurred in the boom period of the late twenties, could not be reduced; nor could they be offset by other savings. Inevitable bankruptcy followed. If a major depression had followed the high-cost period after the recent war, many firms would have found themselves with similar inflexible commitments incurred for extensive construction in the period of high prices. Failures among many of the textile-producing firms in New England have been attributed to antiquated methods and the growth of firms in the lower-labor-cost areas of the South.

Unfortunate policies of management, however, are a frequent cause of excessive costs; and, not infrequently, these policies can be changed only through a change in management. Frequently, the new managements prove successful. They are more willing to make changes and are fearless of tradition. In manufacturing, savings are usually possible through the introduction of more efficient machines, job analysis followed by job simplification, production scheduling, product redesign, new sources of supply, more exact knowledge of the market, etc. In distribution, the biggest single cost is the cost of the goods to be sold. Sometimes, this cost can be reduced; but, more commonly, savings are effectuated in salaries and wages, in rent, or, to a lesser extent, in numerous smaller items of expense.

LACK OF CAPITAL

Lack of capital is often given as the reason for the downfall of many business firms. More frequently, however, failure is the result of poor management, which guessed at costs, prices, inventories, markets, and other policy problems. Often, management did not estimate with exactness how long it would take to launch a new business or a new product. Recently, a man experienced in one trade decided to buy a going business in another. He went over the books carefully; he talked to the suppliers of the current owner; he established the trading area and had a good knowledge of the location and number of prospects. He bought the business only to find out that he should have had sufficient capital to run it at a loss for almost six months while he was increasing his volume of sales to the point necessary to take care of added overhead, larger stocks, and store improvements. Frequently, a prospective businessman opens a new business with his last dollar, expecting the business to pay its own way

from the first day. Experienced business people, on the other hand, allow themselves enough cash to operate in the red, if necessary, for six months to a year, or even longer.

Peculiar as it may sound, a business may be seriously affected by too much business, if it cannot be financed properly and at a competitive money cost. Increasing inventories, slower credit, higher costs of machinery as well as raw materials and supplies, and higher wage rates all take more money; and if management has not anticipated these needs and cannot meet them, drastic adjustments must be made, either by the owners or by the creditors.

FRAUDULENT MANAGEMENT

The commitment of fraudulent acts by managerial employees has led many firms to failure. This is particularly true of small firms in which the acts of single individuals may have proved so serious as to lead to failure. Fraudulent actions which might be serious for a small business are less likely to prove so for larger ones. Furthermore, fraudulent activity in larger companies is generally apprehended by auditors or other officials before it becomes a threat to solvency. Occasionally, large companies with nationwide dealings may fail on this account. An example of difficulties caused by fraud is the case of McKesson & Robbins, Inc., discussed in Chapter 32.

Fraud by a single employee or a small group can generally be prevented by the maintenance of complete and revealing records, periodically reviewed by the owners or their agents. Bonding, of course, helps to protect the interests of a firm from financial loss by fraud of its employees. The best preventive, however, is careful selection of employees. This is particularly important for key officials who, because of their position, may be able to commit frauds that would be detected and stopped if attempted by lesser employees. Generally, frauds of such magnitude as would wreck a firm are not first offenses. Unless the owners and board of directors expect to condone fraud for their own ends, as is sometimes the case, the board should carefully investigate the past records and reputations of candidates for top positions. It should also establish a personnel policy which demands similar investigation of other employees.

ADVERSE GOVERNMENT ACTION

The corporation receives its birthright from the state; in a few instances, some governmental act may spell its death knell. Generally speaking, the only acts of importance in bringing about failures are those calling for change. In our discussion here, the wisdom of governmental acts is not questioned or criticized. Certain acts cause businesses to fail as a byproduct of some basic social good. In other cases, the acts may be

wisely or unwisely directed at some particular type of business. Our consideration will be only the effect upon a particular business firm, not the basic good or evil of the acts to society.

New tax legislation is one of the governmental acts most commonly blamed for business failures. The criticism is usually directed toward a change in taxes, since existing taxes are already provided for in the business structure. Taxes on net incomes are designed to be variable with net income and cannot be a direct cause of business failure. However, a net income tax may reduce the returns of a business to the point where they are not large enough to encourage capital to take the risks involved.

Tariff revisions may have marked effects upon individual businesses. Those industries which have considerable foreign competition and which do not enjoy much export business are favorably affected by tariff increases. The dye, steel, optical goods, and precision instruments producers are examples of these. On the other hand, concerns with little or no foreign competition, or concerns interested in exporting a considerable portion of their products, are adversely affected by tariff increases. Tariffs reduce the ability of foreign countries to buy. For this reason, industries with a large export market and with little foreign competition are inclined to favor low tariffs. In all the discussions of reciprocal trade agreements prior to World War II, a major consideration was always whether a reduction in tariffs would adversely affect business firms which had been built up on the basis of a high import tariff and which were unable to adjust for competition resulting from a reduction in tariff.

Legislation, aside from taxes and tariffs, may also have adverse effects on individual business firms. Imposition of child-labor and wages and hours laws has affected many businesses adversely. Generally, the public and business have little sympathy for such firms. Except in unusual circumstances, laws of this type only reflect what more able and enlightened management already practices. Management that has failed to adjust for these trends in business ethics before they become laws finds little sympathy when the law forces their firms out of business.

In the early thirties, government reforms for industry were popular in combating the depression. The most important was the National Industrial Recovery Act. This act was intended to facilitate recovery, but it was well known that certain industries would be affected adversely. For some businesses, the act resulted in increased costs; but, since there were no counter adjustments possible for management, failure resulted. For some firms, some of the changes resulting from codification of industrial relations were so drastic that management could not possibly have anticipated them. This was particularly true of many small firms which existed on the fact that they had policies different from those of the bulk of large producers whose policies were written in the official codes.

During World War II, the imposition of price controls, labor controls, and materials controls had adverse effects upon many firms. Producers

frequently found that price ceilings set on their products would not cover costs. Whether or not the ceilings represented a reasonable or unreasonable governmental action is debatable, but many firms had to close their doors as a result of the administration of the law.

The effect of court decisions may also be significant. Reinterpretation of existing laws may greatly change the cost of doing business, and other court actions may actually dissolve business enterprises. Examples of the latter are the Supreme Court decrees compelling the dissolution of the Northern Securities Corporation, the Standard Oil Company, the American Tobacco Company, and, more recently, certain public-utility holding companies. Decisions of the type that influence costs or ways of doing business are those dealing with patent cases, trade associations, labor relations, taxation, basing-point systems, principles of fair trading, and trusts in restraint of competition.

The literature of business history is replete with illustrations of failures attributable to the acts of government. For the student of finance, it is, however, important to realize that each individual business—and, for that matter, all business—is merely a part of a complex society over which government—federal, state, and local—has a tremendous power. Sometimes, the acts of government are detrimental to the interests of a single business; and, at times, they are detrimental to all business. Generally, these acts are intended to serve some social good. Not infrequently, governmental acts may be the product of misguided, uninformed, or even dishonest public officials.

What protection does business have? The individuals involved in management should be leading citizens themselves so as to fulfill their own obligation to government. They can also do much to assist others to be good citizens who can direct their officials intelligently. Within a firm, the employees are susceptible to the ideas of management. So also are the customers. Through its associations, business can exert a powerful influence on public thinking.

As for the operation of individual firms, management should study the trends of political thought. By and large, legislation comes about only as a result of long, slow developments in industry and society. The individual business should prepare itself for enactment into law of these trends in public thinking. Quite probably, many businesses cannot make these adjustments; but, where they can, management is negligent if it is ignorant of the trends or refuses to make the adjustments.

ADVERSE LABOR OR OTHER GROUP ACTION

Government is by no means the only type of group action which has or may have adverse effects upon the solvency of a business firm. Generally speaking, labor has an interest in the continued prosperity of the firms by which it is employed. It is indeed a narrow-sighted labor

policy which brings immediate gains to labor but ultimate failure to business. However, one investigator has found that nonmanagerial employees have inadequate knowledge of the financial status of those for whom they work. This conclusion, surprisingly, was found for such basic matters as magnitude of earnings, proportion of total costs accruing to labor, and relationship of top salaries to other wages and salaries.[1]

With inaccurate ideas about the financial affairs of business, it is not unusual for labor, through group action, to impose some undue burdens on employers. The best preventive for this type of action is long-range planning and programming by management of educational activities with both the rank and file of labor and the direct negotiators for labor. In recent years, much stress has been placed upon this type of activity by firms such as the Studebaker Corporation. This company achieved what appeared to be unusually satisfactory labor relations. However, with the return of fully competitive conditions in the auto industry in the early 1950's, it developed that these relations were based at least in part on wage systems more favorable than those of the industry generally. The company experienced considerable difficulty in obtaining readjustments in its pay scales to approximate those of the major producers.

A more common type of labor action which has adverse effects upon business firms is that which can be handled by the bulk of the concerns affected but not by certain ones—generally the marginal firms. As labor becomes more powerful in imposing its demands on industry, failures from such actions become more prevalent. Strikes have commonly spelled failure. The sale and dissolution of the *Philadelphia Record* in 1947 has been attributed to adverse labor action. This well-known daily newspaper had operated successfully for many years, but a prolonged strike placed such a burden on management that it finally decided to suspend operations. The majority of failures attributed to labor action are of smaller firms which operated with relatively high costs, particularly labor costs. Sometimes, firms may have a satisfactory cost structure but cannot survive a prolonged strike against themselves or firms to which they are supplying products. Extensive and long strikes against automobile producers have, on several occasions, led to the failure of small exclusive subcontractors.

There is little relief for management from the demands of labor which can be met by the majority of the firms concerned but not by particular ones. This is one of the unfortunate features of high-cost operation or of exclusive dependence upon the welfare of other concerns. Mechanization to reduce the proportion of labor cost to total cost may help. This has proved highly effective in the mining industry, but many firms cannot accomplish it. Small producers operating with a single subcontract as the major source of income are naturally dependent upon

[1] A. M. Surface, "Penalties of Economic Ignorance," address before the Industrial Session, Annual Conference of the New England Council, Boston, 1946.

that contract for continued solvency. Such firms can partially protect themselves by having facilities and plans for easy and quick conversion to the production of a readily salable product to tide them over any difficulty with their contractors.

Group action from sources other than labor may have adverse effects upon business firms, particularly small ones. Newspaper and radio crusading against certain questionable businesses has been known to bring ruin to firms involved, though the crusade may have been socially justified. The management of any business subject to such criticism should be aware of it prior to the occurrence of the incident, since the public press and radio tend to reflect only what is already widely accepted. Religious groups also play a part in business. Religious condemnations of card playing, slot machines, or drinking of alcoholic beverages have all been important to producers involved. Fortunately for management, such condemnation is not something that springs up overnight. Group action may flare up at any time, but it can be anticipated. The efforts of producers of liquor in recent years to preach moderation have been made largely to forestall or prevent anticipated adverse group action.

ACTS OF GOD

Many business firms, particularly small ones, have succumbed to the occurrence of events classed legally as "acts of God." Fires, tornadoes, earthquakes, etc., come in this category. The loss suffered from these disasters usually comes on suddenly and is frequently fatal to business enterprises. Loss from such causes may be prevented or substantially reduced by several means. Recognition of the possibility of the occurrence of an act of God is essential, since generally time does not permit much to be done once the incident occurs.

The most common source of relief is found in insurance, whereby the specific risk is transferred to specialists in risk-bearing. The vast majority of businesses carry insurance covering a wide range of possible losses from fire, wind, hail, earthquake, or other damage. Most risks of this type are insurable; but individual business may find the cost of coverage a considerable burden, which in some instances discourages management from acquiring adequate coverage. It should be remembered, however, that high premiums are an indication of a high probability of experiencing the risk in question. Losses sustained from acts of God which are normally insurable are quite inexcusable in good management.

Large firms with scattered properties may establish special reserves for losses of this nature rather than insuring through outside sources. This is a recognized procedure for a firm with several stores or plants. Under these circumstances, the firm recognizes that extensive loss is unlikely and merely girds itself for the minor losses which are likely to occur.

Relief from various forms of property risk is found in proper con-

struction and protection of plants and equipment. Buildings may be designed so as to resist the devastating effects of earthquakes, fire, etc. Adequate fire-fighting equipment may prove to be of great assistance in preventing major loss. Plants engaged in the manufacture of extremely inflammable products may provide special fire precautions and special equipment for fire, with considerable saving in insurance premiums. Management that does not recognize the generally accepted precautions in building and equipping places of business is negligent and should be blamed for losses that occur as a result.

In shifting or lessening the risks of loss through acts of God, the all-important thing is anticipation of their occurrence. Costs of shifting or lessening the risks must always be weighed against the probability and extent of possible loss. Overprotection may jeopardize the financial position of a firm quite as much as underprotection. A small firm can be insurance-poor, just as an individual can be. Certain types of building construction may be so costly as to prohibit their undertaking, even though risks of loss may be reduced far below those normally existing for a business.

DEPRESSIONS—A CAUSE OF FAILURE?

General depressions in business activity have been omitted purposely from the list of causes of business failures, even though it is common to refer to a particular failure as being caused by a depression. The high rate of failures in business depressions is generally the result of the inability of firms to make adjustments to compensate for changed financial and commercial conditions. Thus, the real underlying causes are to be found not in the depressions themselves but rather in the practices of firms which make them unprepared to execute needed adjustments to meet fluctuations in business conditions. Depression periods call for ingenuity and aggressive action on the part of management, as well as a flexible business structure. Debts incurred in favorable times may well prove the weak spot in the corporate structure in a depression. The owners of capital are always more cautious in making investments in depression periods; hence, it behooves management to establish good records in periods of prosperity and to be cognizant of what will be demanded of them in attempting to obtain capital in depression times. In periods of depression, consumers have the same desires as in boom times but lack the wherewithal to enter the market. Both producers and distributors have to be content with lower prices and smaller volume. The important thing is to have costs that are flexible enough to withstand curtailment both in total and in unit of output.

Business depressions have varied incidence. Necessity goods and services show greater resistance to depression than luxury items. Raw materials are generally more adversely affected by depressions than are fin-

ished goods. In a depression, businesses that carry large inventories have a more difficult problem than those with small inventories. Businesses in which the production process is a long one have more trouble than those with short processes. Finally, businesses that are closely linked to other businesses for supply or markets are more likely to experience difficulty in a depression than those that operate more independently and can shift their relationships.

CONSEQUENCES OF FAILURE

Whenever the failure of a business enterprise occurs, it is obviously essential to resolve the condition in order to protect the rights of all parties of interest. Also involved is the economic welfare of the community where the company is located or even of larger areas. Failure brings to a halt the normal self-sustaining activities of a going concern and disrupts the flow of the economic processes generally.

Since the financial difficulties preclude free and voluntary functioning by management, the creditors naturally assume or inherit the responsibility for action. In the case of a small enterprise, creditors often find it possible to obtain unanimous agreement on a solution but, where there is disagreement or the size of the company makes voluntary action unwieldy, there is no escape from formal processing by the courts. In either event, the decision must be made whether to liquidate or reorganize the company.

LIQUIDATION

Consistent with its ordinary connotation, liquidation means the dissolution and winding-up of the affairs of the distressed enterprise. This solution is seldom applicable to large corporations mainly because of the desire to avoid the resulting economic dislocation. However, it is not an uncommon means of settling the affairs of relatively small institutions. Preferably, if unanimous consent by the creditors can be obtained, liquidation should be effected by private negotiation and settlement because, generally, such a course of action is less expensive and time-consuming. However, legal complexities and personal disagreements may often make it impossible to proceed on a voluntary basis, and there is no escape from resort to the courts. Under these conditions, the creditors elect a trustee subject to the approval of the court, or when they fail to do so, the court may appoint a receiver. Usually, a trustee is named but, in bankruptcy cases, there is little difference in their duties, viz., to liquidate the assets and use the proceeds (1) to cover the expenses of administration and (2) to pay "liquidating dividends" to the creditors. Finally, the corporation is dissolved and the receiver or trustee is formally discharged by the court.

AGREEMENT OR COMPOSITION WITH CREDITORS

Failure represents a condition of insolvency which may be (1) *technical*, where the company has insufficient cash to pay its debts even though its assets exceed liabilities, or (2) *outright*, where the liabilities actually exceed the assets. In the first instance, the difficulty is often more a matter of timing than of substance; i.e., given sufficient time, the assets could be converted into cash to meet the obligations. Under these circumstances, when the company is small and the creditors are few in number, it is rather common to work out an agreement or composition with the creditors. The agreement must be signed by all creditors to be effective; and it usually provides for an extension of maturity dates.

Composition agreements may also provide for a scaling-down of the debts. Creditors are, in effect, accepting a smaller certain loss in preference to the greater possible loss and the delay entailed in a receivership or liquidation. While the effect of such agreements is to reorganize the distressed company and permit its continued operation, their primary purpose is basically one of debt compromise and settlement. As we shall see in the ensuing discussion, the larger process of reorganization is a deliberate and comprehensive plan of rehabilitation—not only to provide for the settlement of claims but also to place the company on a sound financial basis for the future.

REORGANIZATION

When the corporation is fairly large and represents widespread and diverse interests, the normal action is to attempt a reorganization. Reorganization is a legal process which, on one hand, is intended to protect the various interests involved and, on the other, endeavors to correct the causes of failure. The second objective is inherently the more difficult since any truly successful reorganization must correct the cause or causes of failure. This means that the financial structure must be revised in a manner consistent with economic realities, additional capital must often be provided, and over-all efficiency should be increased. These are difficult and often contradictory goals.

REORGANIZATION PROCEDURE

During the last quarter of a century, substantial changes have been made in corporation reorganization procedures. These changes may be better understood by having an appreciation of the system as it functioned prior to 1933. This is especially true since much of the original pattern may still be used, and the revisions have significance more particularly as to the rights of the parties involved and in a greater supervisory power for the courts and the Securities and Exchange Commission.

In essence, reorganizations prior to 1933 were effected through an equity receivership in which the properties of the distressed company were transferred to a new corporation by a foreclosure sale. The equity receivership is still legal, but it is no longer in common use as a vehicle of reorganization. Even so, it may be studied in some detail in order to obtain historical background and because many of the various committees and numerous practices used to effectuate reorganization are still applicable under current methods.

NATURE OF REORGANIZATION PROCESS PRIOR TO 1933

Under the old receivership plan, four major steps were involved, as follows:

1. Appointment of a receiver to operate the company and, at the same time, allow the proper machinery of reorganization to get under way.
2. Organization of protective committees to protect the interests of security holders.
3. Appointment of reorganization committees to formulate the reorganization plan.
4. Approval by the proper courts and, usually, a foreclosure sale to make the plan for reorganization effective.

Appointment of the Receiver. Failure gives rise to loss of confidence and to numerous conflicts of interest among the various creditors and owners, and creates a situation where it is highly important that the company be placed in the hands of some nonpartisan but competent party. Under the old receivership plan, such independent administration was obtained by the appointment of a receiver by the proper court.[2] The receiver is endowed with special authority permitting various priorities and privileges which are intended to aid in the rehabilitation of operations. For example, he may raise capital by issuing receivers' certificates having prior lien over all other obligations or at least those in default. Again, the claims of the old creditors of the company may be relegated to a junior position, thereby permitting the receiver to buy new materials and supplies more favorably. The receiver, however, has no functional responsibility in working out a plan of reorganization. His job is mainly one of placing the firm on an efficient operating basis and of preserving the property of the company for the various claimants.

Protective Committees. As the name suggests, protective committees are intended to represent and to protect the rights and interests of the various groups of security holders. These committees, by means of formal agreements with creditor and investor interests, have virtually all the

[2] Federal courts were favored when the enterprise was engaged in interstate commerce.

rights of true security holders. This may be seen in the following typical statement of their broad powers of attorney:

Each and every Depositor for himself and not for any other, does hereby, and by the deposit of Bonds hereunder shall be deemed to sell, assign, transfer and deliver to the Committee as from time to time constituted, its successor and assigns, absolutely, each and every Bond deposited hereunder by him, and all his right, title and interest, at law or in equity, in and to the same, and also all his right, title, interest, property and claim at law or in equity by virtue of said Bonds or the Indenture or other instrument securing the same or otherwise, in and to the property and assets of the Railway Company. . . .

The organization of protective committees is largely the result of self-interest, and any group of investors is free to act. Since the committees are not officially appointed by the corporation or by reason of legal requirement, some stimulus is necessary to secure prompt action. Actually, the necessary initiative is usually provided by large security holders with sufficient amounts at stake to warrant an expenditure of money to protect their existing investment. Also, bankers who have previously underwritten the defaulted issues or who are in search of new business readily assume the task of committee organization. As a result of such sponsorship, select groups or other inside interests represented on protective committees are usually in a position to control the plan of reorganization under equity receivership proceedings. Changes discussed in the next two chapters have greatly affected the powers and practices of these committees.

Reorganization Committees. In order that the work of reorganization may be expedited, reorganization committees are created. A reorganization committee frequently consists of representatives selected from each of the leading protective committees. By this process, differences of opinion and interest on the part of holders of the various security issues are ironed out before the formulation of the reorganization plan. Closely allied with the activities of this committee are the bankers who will underwrite the new securities to be floated in connection with the reorganization. Occasionally, the bankers may be appointed as reorganization managers and allowed to conduct the arbitrations and other details necessary to the formation of a reorganization plan. Banker interest is necessary for a successful reorganization, but extreme domination may operate to the detriment of the investors.

Making the Reorganization Plan Effective. The final step under the old equity receivership plan was to make the plan of reorganization effective. This called for court approval of the fairness of the plan and usually required a foreclosure sale for the purpose of transferring the property from the old to the newly organized company. The sale of the corporate property under foreclosure was usually a matter of formality because new and independent interests were practically eliminated by the heavy cash requirements for purchase. On the other hand, those in control of the re-

organization were able to make a settlement, largely in the form of securities of the old corporation. Dissenting interests were paid in cash, but they were necessarily in the minority;[3] otherwise, the plan of reorganization could not be considered successful.

Excessive Time and Expense of Old Equity Receivership. Any process of reorganization is inherently subject to some delay and controversy. Investors are reluctant to admit the losses incurred by failure, and there is a tendency to postpone the day of reckoning. It is tempting to believe that better days are just around the corner and that their dawning will restore the distressed company to a satisfactory financial condition. At the same time, reorganization has many of the elements of a showdown; and controversies between the various classes of claimants are sure to develop. Secured creditors are likely to press the privileges of their position, whereas the unsecured creditors and the stockholders may oppose any quick application of such rights. The latter two groups may contend that prevailing values are not representative and that hasty enforcement of prior claims would result in injustice. Needless to say, all of these tactics result in added expense and time-consuming arguments.

In view of the many crosscurrents which are found in reorganization, it is apparent that *blitzkrieg* tactics may be unfair as well as be the cause of unnecessary sacrifices on the part of junior security holders. Thus, fair treatment of the various claimants sometimes requires a reduction of the speed with which reorganization is accomplished. The sponsors of present reorganization procedure sought the accomplishment of both objectives, but only long experience will determine the realization of this goal. One prominent authority in the field of reorganization has declared that the new procedure defeats "expeditious" and "economical" reorganization as well as making it more difficult for it to be "fair" and "honest."[4] However, the true results are in the making, and experience alone will furnish the answer objectively and without bias.

Failure to Provide Full Information and Investor Representation. The old equity receivership procedure, with its many committees, was also conducive to secrecy. Investors found it difficult to find their bearings. They had few dependable sources of information with which to appraise the merits of the committees seeking to represent them; on the other hand, the alternative of inaction bred a fear that their rights would not be protected. The need for such choice may not be eliminated, but it can be relieved by providing investors with greater knowledge of the facts and by giving them assurance that the reorganization proceedings are to be conducted in their interest and with full opportunity for them to express their opinions.

---

[3] Reorganization plans usually require approval by a substantial majority, e.g., two-thirds. As a rule, the minority group is quite small.

[4] Robert T. Swaine, "Democratization of Corporate Reorganization," *Columbia Law Review*, Vol. XXXVIII (1938), p. 256.

As will be shown in the following chapters, the Bankruptcy Act amendments do tend to bring rehabilitation activities into the open and to provide disinterested administration. Security holders are given more freedom to propose and to discuss plans of reorganization; and the creation of a disinterested trustee eliminates the possibility, always present under the old equity receivership, of the reorganization proceedings being dominated by inside interests. Formerly, it was not uncommon to find the old management or its interests directing the activities of bondholders' protective committees for purposes of perpetuating their own control. Under such circumstances, reorganization became a device not of economic rehabilitation but of retention of corporate control.[5]

QUESTIONS AND PROBLEMS

1. How can the lessons of failure be of value to the management of a going concern?
2. Distinguish between the underlying and the apparent causes of failure.
3. Explain why business failures were small in number in the period immediately following World War II.
4. Under what circumstances does the economist view business failures as necessary to the healthy functioning of the economy?
5. Why is it possible for business firms to continue operating at a deficit over a period of years?
6. To what extent and under what circumstances should management be held responsible for a failure?
7. Diversification of product is frequently cited as a guard against failure. When may diversification accelerate a failure?
8. Government action for the public good may result in a serious obstacle to particular firms. Does the government ever make settlement with such businesses? Should it do so?
9. Why should creditors have the power to cause a business to close its doors?
10. Creditors may have more protection against inflation than stockholders because they often assume control in the event of failure. Discuss.
11. What are the best means of insuring against failure during a depression?
12. How can inexperienced management make use of the experience of successful businessmen?
13. Can you design criteria for deciding when a business should be "reorganized" instead of "liquidated"?
14. Contrast the causes of failure listed in *Dun's Review and Modern Industry* with those developed in the text on pp. 648–57. Are the lists complementary or contradictatory? Explain.

REFERENCES

BOSLAND, CHELCIE C. *Corporation Finance and Regulation*, chap. xiv. New York: The Ronald Press Co., 1949.

BRADLEY, JOSEPH H. *Fundamentals of Corporation Finance*, chap. xxxi. New York: Rinehart & Co., 1959.

[5] *Duporquet Huot and M. Co.* v. *Evans*, 297 U.S. 216.

Buchanan, N. S. *The Economics of Corporate Enterprise*, chap. xii. New York: Henry Holt & Co., Inc., 1940.

Burtchett, Floyd F., and Hicks, Clifford M. *Corporation Finance*, chap. xxxvi, 3d ed. Lincoln, Nebraska: Johnsen Publishing Co., 1959.

Dewing, A. S. *Financial Policy of Corporations*, chap. xxxviii. New York: The Ronald Press Co., 1953.

Gerstenberg, Charles W. *Financial Organization and Management*, chap. xxvi. 4th rev. ed. Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1959.

Hoagland, H. E. *Corporation Finance*, chap. xli. New York: McGraw-Hill Book Co., Inc., 1947.

Osborn, Richards C. *Corporation Finance*, chap. xxv. New York: Harper & Brothers, 1959.

Chapter 32 ►

REORGANIZATION PROCEDURE—INDUSTRIALS AND PUBLIC UTILITIES

THE PROCEDURES discussed in the preceding chapter are still legal, but they have been largely outmoded by amendments to the federal Bankruptcy Act. As a result of these changes in the bankruptcy law, there is now a difference in the reorganization procedure for railroads and that prescribed for industrial and public-utility companies. There is no peculiarity of financial arrangement which warrants this distinction, and it is more likely the result of the influence of the federal regulatory agencies which are concerned with these fields of enterprise.

Having no jurisdiction over the railroads, the Securities and Exchange Commission is free to make recommendations to Congress only with reference to public-utility and industrial corporations. At least, to do otherwise means a violation of the usual courtesies which are extended to other agencies of the government, as well as a presumption to speak in behalf of their responsibilities. As a result, the recommendations made by the Securities and Exchange Commission with respect to reorganization[1] did not encompass the railroads. Reorganization procedure applicable to railroads is set forth in Chapter VIII of the Bankruptcy Act (commonly referred to as Section 77) and will be discussed separately in the next chapter. Provisions covering the reorganization of industrial and public-utility companies are contained in Chapters X and XI of the Bankruptcy Act.

BANKRUPTCY ACT OF 1898

From 1898 to 1933, there was little comprehensive statutory enactment applicable to the reorganization of companies that had failed. The Bank-

[1] Securities and Exchange Commission, *Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees*, Parts I–VII (Washington, D.C.: U.S. Government Printing Office, 1936–39), which was made pursuant to Section 211 of the Securities Exchange Act of 1934.

ruptcy Act of 1898 did provide some facilities for the rehabilitation of companies in distress by a composition whereby the creditors simply voted to scale down the debtor's obligations. This agreement was subject to court approval in order to assure fair and equitable treatment of all parties who were affected by the adjustment. By this means, resumption of business by distressed companies was facilitated; but reorganization, in the modern sense of true rehabilitation of a sick business, was not possible.

EFFECT OF ECONOMIC CONDITIONS

The repercussions of the economic dislocation of the early thirties did not impinge solely upon industrial enterprise; it also deeply affected agriculture and seriously upset the financial stability of many municipalities. Recognizing the resulting need for reorganization, Congress passed enabling legislation in the form of amendments to the federal Bankruptcy Act to fit the more specific requirements of each major area. Thus, laws were passed to facilitate the reorganization of farm organizations, municipalities, railroads, and other business corporations. Our concern is with the last two groups.

It is no longer possible, at this late date, to feel the acute sense of financial panic which was prevalent in the early thirties; but there can be little question as to the extent of the distress. The philosophy of the amendments to the Bankruptcy Act passed in 1933, 1934, 1935, and 1938 was in many respects responsive to the changed attitude created by the depression. The new laws were not passed simply to effect technical improvement in reorganization methods. They were equally prompted by a new belief in the rehabilitation of honest debtors as the best means of serving the social and commercial needs of the nation. Experience had shown that drastic liquidation destroyed economic balances by dumping on an already crowded market bankrupt stocks at sacrifice prices, and there was hope that prompt and liberal treatment of companies in distress would eliminate this problem. Relief was expected to increase the volume of business and to diminish the amount of unemployment.

SECTION 77B

The foregoing influences were particularly reflected in the amendments to the Bankruptcy Act which appeared in 1934.[2] These amendments, constituting Section 77B, contained such important changes as the following:[3]

[2] As stated earlier in this chapter, Section 77, which was passed in 1933, related only to railroads; but its essential features are similar to Section 77B, which applied to other fields of enterprise.

[3] James M. Rosenberg, "Reorganization Yesterday Today Tomorrow," *Virginia Law Review*, Vol. XXV, No. 2 (December, 1938), pp. 129–64, for an historical review of reorganization procedure.

Power to Compel Compliance with Plan of Reorganization. The court was given the power to make binding on all parties a plan of reorganization which it considered to be fair and equitable, if it had the approval of two thirds of the secured creditors and a majority of the stockholders. Under earlier receivership proceedings, minority interests were free to dissent and to demand the liquidation of their interest.

Discontinuance of Ancillary Proceedings. Equity receivership frequently required the appointment of ancillary receivers in addition to the receiver appointed by the court having primary jurisdiction. This was necessary because of the concomitant jurisdiction of other courts in the area in which property of the insolvent company was located. Usually, an effort was made to have the same individual act as a common receiver; but the arrangement was needlessly technical and complicated, to say the least. Section 77B ended the need for such ancillary proceedings.

Increased Supervisory Powers of the Court. No powers were given to either the court or the trustee to work out a plan of reorganization; but there was a marked increase in authority to scrutinize proxies, deposit agreements, and numerous other phases of reorganization practice.

Submission of Plans of Reorganization. As a means of encouraging widespread interest in the plan of reorganization, the debtor was free to submit such a plan without prior consent; and as few as one fourth of the secured creditors were likewise in a position to act. It will be remembered that, under receivership proceedings, the responsibility for the preparation of a plan of reorganization rested mainly with a reorganization committee; and the interests of investors were intended to be represented by protective committees.

Such streamlining of reorganization proceedings was intended to expedite relief for the debtor as well as to encourage active participation by investors. Prompt action was also stimulated by permitting the debtor himself to serve as trustee. The appointment of the debtor as trustee appeared to be justified because the security holders were given the right to express their approval or disapproval of the trustees who were appointed. Moreover, the widespread character of failure in the depression years had done much to take away the sting and stigma of insolvency. At the same time, the suppression of many familiar rights of creditors and investors is readily apparent; and in the short space of four years, there was a sweeping reform of the whole bankruptcy procedure. This was contained in the Chandler Act, which may now be discussed.

NATURE AND PURPOSE OF CHANDLER ACT

The Chandler Act, which became effective in September, 1938, introduced many important amendments to the Bankruptcy Act of 1898. The act established formal procedure covering the reorganization of distressed units or companies in many fields of activity; but our attention will be confined here to Chapters X and XI, relating to industrial and public-utility companies. Chapter X of the act, with its provisions for comprehensive reorganization, will be studied at length; the more informal and limited provisions of Chapter XI will be presented only in summary.

CHAPTER XI OF THE BANKRUPTCY ACT

Recognizing the possible complications of reorganization procedure, it was the purpose of Chapter XI of the Bankruptcy Act to provide for the less serious cases of insolvency. In many respects, it is a substitute for the composition arrangement of the Bankruptcy Act of 1898. It is applicable only to companies with unsecured debts, and proceedings may be initiated only by the debtor. Both of these features limit the use of Chapter XI; and the reorganization of most large companies, consequently, is effected under the more comprehensive provisions of Chapter X.

Unlike Chapter X of the Bankruptcy Act, which provides numerous safeguards to protect the rights of independent investors, Chapter XI is built around the principle of relief for the debtor.[4] Under Chapter XI, the debtor usually retains possession of the property and operates the business under the supervision of the court. The debtor takes the initiative in formulating a plan of adjustment, and the creditors have only the opportunity of rejecting or accepting the proposal. The usual confirmation by the court of such arrangements is required; but it is clear that the debtor plays the primary role in such proceedings, whereas the creditor is largely limited to a more passive role of giving or withholding his assent to a proposed settlement.

Since proceedings under Chapter X may not be undertaken unless it can be shown that relief is not possible under Chapter XI,[5] we may note the conditions bearing upon the course of action. The Securities and Exchange Commission contends that the provisions of Chapter XI are applicable mainly to situations involving strictly debtor-creditor relations "where there are no public investor interests concerned which require the protective measures and safeguards afforded under Chapter X."[6] This view has been sustained in one court decision but, in another, there was disagreement with the Commission. In the latter instance, there were 425 public investors holding a portion of the common stock, representing an investment of about $350,000, but the court held that the simplicity of

[4] See footnote 8 in the court's opinion in the case of *Securities and Exchange Commission* v. *United States Realty and Improvement Company*, 310 U.S. 434, 451, for the statement that Chapter XI "was sponsored by the National Association of Credit Men and other groups of creditors' representatives expert in bankruptcy . . . and that . . . their business of representing trade creditors in small and middle-sized commercial failures is an important factor in the background. . . ."

[5] W. R. Montgomery, "Defects in Chapter XI of the Bankruptcy Act and Suggested Amendments," *Virginia Law Review*, Vol. XXV (June, 1939), pp. 881–85. Section 130 (7) requires that a petition under Chapter X, among other things, shall state "the specific facts showing the need for relief under this chapter and any adequate relief cannot be obtained under Chapter XI of this Act." See also *Collier on Bankruptcy*, 1947 Supplement to Vol. C (Albany: Matthew Bender & Co.), p. 106.

[6] Securities and Exchange Commission, *Twenty-first Annual Report for the Fiscal Year Ended June 30, 1955* (Washington, D.C.: U.S. Government Printing Office), p. 93.

the plan of settlement made possible the use of the provisions of Chapter XI. To generalize, it may be observed that the general criteria seem to be clear, but their applicability will vary according to opinion covering the facts of the specific case.

CHAPTER X OF THE BANKRUPTCY ACT

Chapter X of the Bankruptcy Act was the result of an extensive study of reorganization practices by the Securities and Exchange Commission. Reflecting this sponsorship, it is not surprising that procedure is provided that limits the activities and powers of inside interests and protects the rights of independent investors. These objectives will be seen in the analysis of the following outstanding features and provisions: (1) filing of the petition for reorganization; (2) appointment of a disinterested trustee; (3) advisory capacity of the Securities and Exchange Commission; and (4) preparation, acceptance, and confirmation of the plan of reorganization.

CONDITIONS FOR FILING OF THE PETITION FOR REORGANIZATION

A petition for reorganization may be filed by a corporation, by three or more creditors having claims amounting in the aggregate to $5,000 or over, or by an indenture trustee.[7] A voluntary petition must state that the corporation "is insolvent or unable to pay its debts as they mature" and set forth the facts relating to the "nature of the business of the corporation, the assets, liabilities, capital stock, and financial condition of the corporation, the need for relief, and express the desire of the petitioner or petitioners that a plan be effected" (Sec. 130). When the creditors or indenture trustee files the petition,[8] there is need to show that "the corporation was adjudged a bankrupt," or "that a proceeding to foreclose a mortgage" had been taken, or that other acts of a similar character had been initiated. Another important qualification is that the petition set forth the facts showing that "adequate relief cannot be obtained under Chapter XI. . . ."

OPPORTUNITY FOR ANSWERS

Following the filing of the petition, adequate opportunity is provided to file answers by any interested party. The debtor himself may respond within a period of ten days following the service of the subpoena or

[7] The Bankruptcy Act states that "'indenture trustee' shall mean a trustee under a mortgage, deed of trust, or indenture, pursuant to which there are securities outstanding, other than voting-trust certificates, constituting claims against a debtor or claims secured by a lien upon any of its property" (Art. II, sec. 106 [8]).

[8] This is known as an "involuntary petition."

within whatever period of time is set by the court. Parties other than the debtor may file answers at any time prior to the first date set for the hearings. Stockholders, creditors, and indenture trustees are therefore in a position to take exception to the charges made in a petition and to have their objections passed upon by the court. This right to answer individually differs from procedure established under Section 77B, when it was necessary for opposing stockholders and creditors to act jointly and to represent a specified percentage of the total claims. Such increased liberality for hearing has caused one writer to observe: "Whereas the danger of a 'strike suit' has been lessened, the danger of a 'strike' answer has been enhanced."[9] On the other hand, one authority states that this is one of the outstanding features of the law, since it gives all interested parties opportunities to be heard.[10]

APPROVAL OR DISMISSAL OF PETITION

The act declares that "the judge shall enter an order approving the petition, if satisfied that it complies with the requirements of this chapter and has been filed in good faith, or dismissing it if not so satisfied." The criterion of good faith is included largely as a result of the strike suits referred to above, and the act went so far as to set forth certain grounds which were deemed to indicate the lack of good faith. These are as follows (Sec. 146): (1) the acquisition of claims for the express purpose of filing the petition; (2) the possibility that adequate relief could be secured under Chapter XI; (3) the knowledge that a plan of reorganization cannot reasonably be effected; and (4) the probability that the best interests of the stockholders and creditors would be better served by prior proceedings.

It is obvious that these criteria are by no means absolute, and the courts necessarily have to determine their application in the light of the facts of each individual case. For example, the question as to whether or not adequate relief may be provided under Chapter XI would, for the most part, be a matter of opinion. This alternative does not arise in the case of companies having secured debt; but where there is an absence of such debt, the opinion is definitely present and may easily be the cause of dispute. Some companies have shown preference for the simpler procedure of Chapter XI, particularly because it permits the debtor to remain in control. Also, the debtor alone may apply for relief under this section; creditors may initiate proceedings only under Chapter X of the Bankruptcy Act. As a result of these conditions, there is a "possibility that the investor safeguards of Chapter X of the Bankruptcy Act might be nullified by im-

[9] John Gerdes, "Corporate Reorganizations: Changes Effected by Chapter X of the Bankruptcy Act," *Harvard Law Review*, Vol. LII, No. 1 (November, 1938), p. 7.

[10] H. E. Hoagland, *Corporation Finance* (New York: McGraw-Hill Book Co., Inc., 1947), p. 739

proper resort to proceedings under Chapter XI of that Act."[11] Indeed, the priority of Chapter XI proceedings as a test of "good faith" may, in the case of companies having no secured debt, have great effect upon the form and character of reorganization proceedings in the future.

Neither is the acquisition of claims for the purpose of filing a petition so readily classified as to the good faith of the purchaser. Trading in securities is a perfectly normal transaction, and it would not always be easy to determine the intent of individuals buying securities in the open market. Again, the expected correction of difficulties through reorganization is not resolved simply into a state of positive finding. The final test of good faith is more certain because the tangibility of evidence should facilitate the determination by the court as to whether or not the interest of creditors and stockholders will be better served by prior proceedings.

APPOINTMENT OF THE TRUSTEE

Assuming the approval of the petition, the judge is then required to appoint a disinterested trustee, or trustees, whenever the indebtedness of the debtor is $250,000 or greater. When the claims are less than this amount, the appointment is a matter of option with the court; and either an outsider or the debtor himself may be named. In either event, the trustee becomes the agent of the court and is responsible accordingly. This means that the court may direct the trustee to investigate and examine the pertinent facts with reference to the condition of the debtor. Such study may include an analysis of the financial condition and of the desirability of continuing the business, an examination for the purpose of uncovering acts of fraud or other irregularities, etc. (Sec. 167).

The Tests of Disinterestedness. One of the most controversial points which arose in connection with the passage of the Chandler Act was the requirement compelling the appointment of a disinterested trustee. It literally means what it says, viz., that the trustee shall be free from any special or individual interest. This may be seen in the criteria of disinterestedness which are set forth in Section 158, where it is stated that "a person shall not be deemed disinterested" under the following conditions: (1) if he is a creditor or a stockholder of the debtor; (2) if he was an underwriter of any of the securities for a period of 5 years preceding the filing of the petition; (3) if he performed service within 2 years of the filing date as the director, officer, employee, or attorney of the debtor or underwriter; and (4) if there is any other evidence of direct or indirect relationship to either the debtor or the underwriter. These tests apply equally to attorneys appointed to represent the trustee.

Appointment of Additional Trustees and Attorneys. The fear was expressed in many quarters that the requirement of disinterestedness on

[11] Securities and Exchange Commission, *Sixth Annual Report for the Fiscal Year Ended June 30, 1940* (Washington, D.C.: U.S. Government Printing Office), p. 55.

the part of the trustee and his attorney would necessarily mean the appointment of inexperienced persons. This argument was met by proponents of the measure by pointing out that the provisions of the act permitted the selection of additional trustees and attorneys.[12] As to the former, "the judge may . . . appoint as an additional trustee a person who is a director, officer, or employee of the debtor" (Sec. 156). The duties of the additional trustees are limited to the operations of the business, and they have no responsibilities in connection with the preparation of the plan of reorganization.

As to the employment of additional attorneys, the act declares that "the trustee may, with the approval of the judge, employ an attorney who is not disinterested." The duties of such additional attorneys must be for purposes other than that of representing the trustee in conducting the reorganization proceedings. It is also possible for the trustee to serve as his own attorney where this meets with the consent of all the interested parties.[13]

Another criticism of the appointment of disinterested trustees and attorneys is the danger of abuse by the use of such appointments for purposes of political patronage. While it is impossible to obtain any authoritative evaluation of this hazard, it is fair to say that the possibilities are readily apparent. Some protection against political influence in the selection of a trustee is provided by the provision for hearings where objections may be raised "to the retention in office upon the ground that he is not qualified or not disinterested. . . ."

Why a Disinterested Trustee? Since personal interest has long been advanced as an incentive for action and results, it is important to take stock of the reasons for the requirement that a disinterested trustee be appointed to administer reorganization proceedings. To pose the question more specifically: If personal interest can be relied upon as a motivating force for the conduct of normal business operations, why may it not also be used in the case of reorganization? The answer to this query took form largely as a result of the investigation by the Securities and Exchange Commission of the old equity receivership procedure in which the responsibilities for working out a plan of reorganization rested mainly with a reorganization committee made up of private interests or with friendly banker management. As a result of the Commission's findings, it was declared that independent investors were not adequately represented and that inside interests were more interested in maintaining control than in working out a fair plan of reorganization.

[12] Gerdes, *op. cit.*, p. 10.

[13] In the reorganization of the Reynolds Investing Company, there were two trustees who also acted as their own attorneys. See John Gerdes, "Recent Developments in Corporate Reorganizations under the Bankruptcy Act," *Virginia Law Review*, Vol. XXVI, No. 7 (May, 1940), p. 1003, n. 28, where it is stated: "At request of the Judge, and with the consent of all the interested parties, they are acting as their own attorneys."

Preparation of the Plan of Reorganization. Under present reorganization proceedings, the trustee assumes the responsibility for reorganization; and the law "gives him the sole authority to formulate, present and file the initial reorganization plan."[14] The duties of the trustee extend far beyond those of a neutral conservator; and he assumes, in fact, the role of executive management during the period of reorganization. All interested parties are invited to submit plans; but these plans are brought to a head in the trustee, who, in turn, submits the final result to the court. Under the old equity receivership arrangement, no one was charged specifically with the task of reorganization; and it was usually assumed voluntarily by inside interests. Now, there is ordered separation between those directing the reorganization and the old management. The chief purpose of this separation is to preserve the independence of rehabilitation, and one writer has said that "the most important single change . . . in the process of corporate reorganization under the Bankruptcy Act is to divorce the whole procedure from the management of the corporation."[15]

After the trustee has formulated a plan, he submits it to the court. The court then sets a time for a hearing on the plan and on any objections, amendments, or substitute plans which may be proposed by the debtor or by any creditor or stockholder.

NATURE OF THE DUTIES OF THE SECURITIES AND EXCHANGE COMMISSION

As the intended guardian of the rights of investors, it is not surprising that the Bankruptcy Act places much responsibility on the Securities and Exchange Commission. The court must ask the advice of the Commission in all cases where the debts of the company in reorganization exceed $3,000,000; where the amount is less, reference to the Commission by the court is optional. For companies having debts in excess of $3,000,000, the judge has no authority to approve a plan of reorganization without this advice unless the Commission has given notification that it did not wish to file a report or unless it has failed to report within the period of time allowed by the court. Also, at the time when the approved plan of reorganization is sent to the interested parties, either the report of the Commission or a summary that it prepares must be sent to all the creditors and stockholders who are affected by the plan.

As a means of facilitating participation by the Commission, the judge is required to give the Commission notice of all hearings and to see that it is furnished with copies of reports rendered by the trustee. Indeed, the Commission may "recommend the form of such reports and summaries" which the trustee prepares on the operations of the business. As a result of

[14] Rosenberg, *op. cit.*, p. 130.

[15] Jules I. Bogen, "The New Bankruptcy Act," *Dun's Review*, August, 1938, pp. 9–12.

its various powers and privileges, the Commission may serve either in the role of an active participant or in the role of an umpire. In the former capacity, the Commission may become a party in interest either by request of the judge or upon its own motion if approved by the judge (Sec. 208). Indicating the extent of its activity, the Commission actively participated during the fiscal year of 1960 in fifty-two reorganization proceedings involving the reorganization of eighty companies with aggregate stated assets of $567,094,000 and aggregate stated indebtedness of $532,-120,000. During the year, the Commission, with court approval, filed notices of appearance in nine new proceedings under Chapter X. These nine new proceedings involved companies with aggregate stated assets of $25,-703,000 and aggregate stated indebtedness of $27,850,000. At the close of the year, the Commission was actively participating in forty-five reorganization proceedings involving seventy-one companies.[16]

PURPOSE OF COMMISSION ADVICE

The main purpose of referring plans of reorganization to the Securities and Exchange Commission is to obtain the benefits of expert opinion in determining the adequacy of reorganization plans which are submitted. Because of its specialized facilities, the Commission is clearly in a position to provide much in the way of research and financial analysis which otherwise would not be available to the courts. Reference to the Commission also gives added assurance of the independence and objectivity of corporate rehabilitation, because friendly and inside interests will necessarily find it more difficult to influence the course of action. Naturally, certain values are lost by curtailing the force of personal interest; but, at the same time, it must be admitted that there is much to be gained by the objective approach. Especially should it serve to produce fair and equitable treatment of all parties; equally important, it should result in greater emphasis on the soundness of the plan of reorganization.

It should be stressed that the Securities and Exchange Commission acts in a purely advisory capacity and has no responsibility for the initiation of a plan of reorganization. Its disinterested advice is intended to be of benefit to both the court and the security holders. To reappraise the value of its functions, the Commission recently sought the comments of the federal judiciary. We may note the response of one judge because of the clear portrayal of the role of the Commission:

> . . . The Commission affords the necessary expert knowledge, the skill, and the uniform approach which individual judges cannot have; and to the district judges in particular, the assistance is unique in its usefulness, and not otherwise to be obtained. The judge is not bound to observe all suggestions of the Commission, but the very fact that he has them before him is assurance of his com-

[16] Securities and Exchange Commission, *Twenty-sixth Annual Report, Fiscal Year Ended June 30, 1960*, p. 153.

plete preparation for adjudication, with the public interest adequately protected.[17]

CRITERIA OF PLANS OF REORGANIZATION

"The ultimate objective of a reorganization under Chapter X is the formulation, acceptance, and consummation of a fair and equitable and feasible plan of reorganization."[18] Stated more succinctly, the two chief criteria by which the Commission determines the acceptability of plans of reorganization are (1) the feasibility of the plans and (2) the fairness of the plans. In the application of these tests, there is necessarily an extensive study of the causes of failure and the past operating record, an appraisal of the quality of management, and a careful examination of the physical and financial condition of the company.

In essence, the feasibility of a plan of reorganization means its practicability, tested by the criteria of whether or not the plan eliminates the causes of past trouble and permits safe and sound operation in the future. On some occasions, the lack of feasibility appears at the very outset of reorganization proceedings. When it is apparent that reorganization is hopeless, the Commission, in the interest of avoiding unnecessary time and expense to all concerned, has frankly reported this opinion to the courts, with the reasons for its position.[19] At other times, the determination of feasibility is reached only after careful study and tedious analysis. Usually, if the underlying business structure is sound, any weakness of feasibility may be remedied by changing the capital structure. Thus, a capitalization that is top-heavy with funded debt may be corrected by the substitution of equity securities. Briefly, then, the test of feasibility is one of determining whether a plan of reorganization will permit a self-supporting operation.

In addition to the criterion of feasibility, plans of reorganization are also judged in the light of their fairness. To be fair, in the words of the Commission, such plans

> must provide full compensatory treatment for claims in the order of their legal and contractual priority, either in cash or securities or both, and . . . the participation granted to junior claims must be based either upon the existence of an equity for them in the enterprise after the satisfaction of prior claims or upon a fresh contribution in money or money's worth necessary to the reorganization of the debtor.[20]

In essence, fairness is measured by the treatment of the rights and priorities of the old security holders; and participation by junior interests is de-

---

[17] Securities and Exchange Commission, *Twenty-first Annual Report, Fiscal Year Ended June 30, 1955*, p. 90.

[18] Securities and Exchange Commission, *Sixth Annual Report for the Fiscal Year Ended June 30, 1940*, p. 64.

[19] *Ibid.*, p. 65.

[20] *Ibid.*

pendent upon the existence of an equity or of a new contribution on their part. The questions that are raised by a determination of these conditions will be discussed more fully in the following chapter.

Of these two tests of plans of reorganization,[21] it is probable that feasibility is the more readily applicable. It may be measured by the objective yardstick of operating performance, and it is free from much of the conflict of interest which necessarily bears upon the question of fairness. The application of both criteria may be seen to advantage by a brief review of two actual cases, both of which reveal difference of opinion with respect to the fairness and feasibility of the plan of reorganization.

Case of Atlas Pipeline Corporation. The proposed reorganization of the Atlas Pipeline Corporation came before the United States District Court in 1941. Its properties consisted of an inland refinery of some 8,000 barrels daily capacity, with pipelines leading into eastern Texas, southern Arkansas, and Louisiana oil fields. Its chief difficulty was the fact that it had no production or independent sales outlets and was at the mercy of both producers of crude oil and purchasers of refined products.

The trustee presented to the court for tentative approval and submission to the creditors a plan of reorganization which already had the approval of representatives of all classes of creditors. The plan was submitted to the Securities and Exchange Commission for consideration; and, in its advisory report to the court, the Commission took the position that the plan of reorganization was "neither fair nor feasible."[22]

In summary, the plan proposed to create a new corporation for the acquisition of assets upon which one of the leading engineering firms of the country, by appointment of the court, fixed a going-concern value of approximately $2,500,000. The plant, pipelines, and accessories were encumbered with both a first and a second mortgage; but there were several thousand dollars of current and free assets in which ordinary creditors, in the event of liquidation, would be entitled to participate. The plan proposed that, after providing for federal and state taxes, the ordinary creditors be paid $0.10 on the dollar in cash, or the equivalent, of their equity in the free assets; that new first-mortgage bonds be issued to the first-mortgage bondholders, whose claims amounted to $961,400, said new bonds to bear 4½ per cent interest instead of 6 per cent, which was the interest rate of the old bonds; and that the second-mortgage creditors would be issued $435,000 of 4 per cent preferred stock in full settlement of their claims, which amounted to $1,500,750. The 4 per cent dividends on the preferred stock were to be contingent, for three years, upon earnings, but unconditional thereafter. In addition to the foregoing, the plan

[21] These two tests are set forth in Section 174 of the act, which declares that "the judge shall enter an order approving the plan or plans which in his opinion . . . are fair and equitable, and feasible. . . ."

[22] Securities and Exchange Commission, *Corporate Reorganization, Release No. 42,* June 7, 1941; *In re Atlas Pipeline Corporation,* 39 F. Supp. 846 (1941).

proposed that an extra $50,000 of first-mortgage bonds were to be sold for cash, at their face value, to one of the holders of second-mortgage bonds, who, in turn, was to sell the bonds to persons participating in the plan, referred to as the "purchasing group." This was for the purpose of adding to the operating capital of the new corporation. Under the plan, 5,000 shares of common stock were to be issued and purchased by the purchasing group at $20 per share. It was further provided that the purchasing group would obligate itself to advance in excess of $200,000, either in cash or credits. The purchasing group, which would own the common stock, would take over the management of the new corporation and would enter into a contract to furnish ample crude oil to keep the refinery running at approximately its capacity.

The Securities and Exchange Commission, in its advisory report, took the position that the foregoing plan of reorganization was neither fair nor feasible. The Commission believed that, although the new plan preserved the position of priority of the old bonds for the entire amount of their claims, there was a dilution of the security behind the bonds. Among other things, the plan contemplated the release, for general corporate use, of $150,000 in cash held by the indenture trustee; and there was also the prospect that the debtor's office building would be sold. As a result, the Commission expressed the opinion that "the property which the first-mortgage bondholders may look to at the end of the debtor's economic life would be less than the property to which they can look for satisfaction of their claims today." As to the second-mortgage bondholders, the Commission felt that they were being asked to make an unreasonable sacrifice, since they were to give up their creditor position for new preferred stock equal to only one third of the principal amount of their claims. The possibility of unfairness arose both from the loss of an existing realizable claim and in comparison with the treatment that was to be given to the unsecured creditors. Likewise, the contingencies of risk arising out of the aforementioned contract which was to be negotiated with the purchasing group created the possibility that the bondholders would be affected adversely.

The court rejected the advisory report of the Commission and held that the plan of reorganization presented by the trustee was both fair and feasible. Although the Commission, in its report, criticized the figures of the trustee in calculating and estimating the prospective earnings and consequent success of the new corporation, the court said that, while no one could be certain as to this matter, it was of the opinion that the trustee had adopted a reasonable and conservative basis for his calculations. This conclusion was borne out by the trustee's own experience over several months, after various improvements and changes in the operations had been instituted. During this period, profits, above interest and depreciation, increased to $334,000 per year.

The court also felt that the feasibility of the plan was further attested,

if not assured, by the fact that the purchasing group, who would have charge of the new management, consisted of men of large means with an assured supply of crude oil, which they agreed to furnish upon a reasonable basis so as to keep the refinery operating at near capacity. The purchasing group's good faith in the practicability and possible success of the plan was evidenced by its willingness to invest $100,000 in the common stock and to extend additional credit or cash for another $200,000. Likewise, the feasibility of the plan was further evidenced by the willingness of bankers and businessmen experienced in the oil industry to approve the plan upon behalf of the first- and second-mortgage bondholders. Under the circumstances, the court said that it would "hesitate to turn it down and adopt the suggestion of the Commission that the properties be scrapped and liquidated as junk." The court then went on to say:

I am impressed that the views of the Commission are somewhat cold-blooded and are based upon the theory that no new security should be issued which is not worth, at the time, its face value. If the organization of the new enterprise was involved that view might be justified, but when you have a situation such as is presented here, where it is the duty of the Court to try to protect the interest of all creditors as far as the assets and circumstances of the debtor permit, a more practical view should be taken.

Based upon the Commission's own calculations, liquidation would wipe out the second-mortgage creditors entirely, except to the extent that they might participate in the free assets along with ordinary creditors.

The court was of the opinion that the plan was fair in that it preserved the position of the first-mortgage bondholders to the full amount of their principal and accrued interest, and the only sacrifice they would make would be in the reduction of their interest rate from 6 per cent to 4½ per cent. Probably the spirit of the law covering the reorganization of embarrassed corporations contemplates some giving and taking by all parties concerned, but at least the protection of the principal would seem to be assured under the rule of absolute priority discussed in the next chapter.[23] In any event, it is likely that the results of reorganization are highly speculative and uncertain.

As to the ordinary creditors, they would receive equivalent of their share in the free assets; and there would be a substantial reduction in tax liability and other obligations which might have a preferred status in the event of liquidation.

The Central States Electric Corporation.[24] This case illustrates a rather complicated situation wherein the plan recommended by the trus-

[23] See pp. 698–700.

[24] *Report of Securities and Exchange Commission on Proposed Plans of Reorganization, Proceedings No. 16–320,* December 19, 1949. Also, see 183 F. 2nd 879 (1950) and 340 U.S. 917 (1951).

tees was held to be fair and feasible by the Securities and Exchange Commission. The plan, as approved by the Commission, was contested in the courts by the various interested groups. The Commission was upheld in the United States Circuit Court of Appeals and the case closed when the Supreme Court denied a writ of certiorari on January 8, 1951.

The Central States Electric Corporation is an investment company registered under the Investment Company Act of 1940. At the time it went into reorganization under Chapter X, it was a closed-end[25] management company. It was incorporated in 1912, but the financial manipulations which caused its troubles dated from 1922. In that year, the Company began a program of investing in North American Company stock. By taking the 10 per cent stock dividend of the North American Company in at market value, the Central States Electric Corporation was able to create an illusion of higher earnings. Central States also traded in North American stock in order to maintain an inflated market price. During 1928 and 1929, four subsidiaries were formed. The parent and its subsidiaries sold nearly half a billion dollars of securities, about half to the public and half to each other. By September, 1929, its assets had a book value of $350,000,000; but, by 1931, its assets had shrunk to $40,000,000, or considerably less than the outstanding debentures and preferred stock. This shrinkage shows clearly what can happen in a high-leverage situation.

During the next ten years, the parent company retired debentures at a discount and rearranged its holdings so as to avoid becoming subject to the Public Utility Holding Company Act of 1935. One subsidiary was closed out, and holdings in another were reduced to minor amounts.

The company filed a petition for reorganization under Chapter X of the National Bankruptcy Act in February, 1942, and was in the process of reorganization until the matter was finally determined in 1951.

A number of plans of reorganization were submitted, in 1949, to the District Court of the United States for the Eastern District of Virginia, including a plan submitted by the trustees. These plans were referred by the District Court to the Securities and Exchange Commission for examination and report. All plans submitted, except the plan submitted by the trustees, were rejected by the Commission, which, however, did accept the trustees' plan as fair, equitable, and feasible. The District Court concurred in this opinion and approved the plan. An appeal was taken from the District Court, on July 6, 1950, to the United States Circuit Court of Appeals. On August 6, 1950, the Court of Appeals affirmed the holding of the District Court. Finally, the case was taken to the United States Su-

[25] A *closed-end* investment company is one in which new stock is not for sale and in which outstanding stock will not be purchased by the company on demand. An *open-end* investment company is one in which new stock is always available for sale and in which outstanding stock will be repurchased on presentation by the stockholder at the *current* market value of the underlying investments.

preme Court, on a writ of certiorari; and, on January 8, 1951, the Supreme Court denied certiorari. The effect of this denial of certiorari was to affirm the holdings of the District Court and the Court of Appeals, thereby affirming the position of the Securities and Exchange Commission that the plan of reorganization submitted by the trustees was fair, equitable, and feasible.

Under the reorganization plan recommended by the Commission and approved by the courts, as explained above, the company was to become an open-end investment company having only one class of outstanding securities, i.e., common stock. One subsidiary, the American Cities Power & Light Corporation, was to be liquidated; and the other, the Blue Ridge Corporation, was to be merged into the reorganized parent. The number of shares of common stock to be initially outstanding would be determined by the value of the assets. The value of the common stock was to be determined by the market value of the assets at closing market prices on the five business days immediately preceding the effective date of the plan. The new common stock was to be redeemable sixty days after presentation at the then current asset value.

Debenture holders were to receive new common stock for the face amount of their interests. The 7 per cent preferred stockholders were to receive the remaining common stock of the new company in exchange for their preferred stock at the liquidating value of $100 per share plus accrued and unpaid dividends. If the market value of the assets meant that the remaining common was inadequate to satisfy their claim, they were to have a share in the contingent assets.[26] The junior preferred stockholders were to get only a claim on the contingent assets. The old common stockholders were to receive nothing.

The plan was also fair in giving no participation to the junior preferred and common. This represented an application of the rule of absolute priority.[27] This rule is that each class of security holders is entitled to its liquidation preference before a junior issue may participate. The plan was held to be feasible because it eliminated fixed charges by not providing for the issuance of senior securities, thereby creating a solvent organization. As was stated in the foregoing paragraphs, the courts affirmed this position of the Securities and Exchange Commission.

PROTECTIVE COMMITTEES

Present reorganization procedures do not nullify further need for the services of protective committees, because there is still need to mobilize

[26] The contingent assets were valued at zero and constituted the value of lawsuits pending against principal officers for damages in compensation for mismanagement and neglect.

[27] See Chapter 33 for discussion.

and organize the interests of investors.[28] However, as was true of Section 77B, the judge is given broad powers to "examine and disregard any provision of a deposit agreement, proxy, power or warrant of attorney, trust mortgage . . . which he finds to be unfair or not consistent with public policy . . ." (Sec. 212). The power of protective committees is also limited by Section 176, which provides that "no person shall, without the consent of the court, solicit any acceptance, conditional or unconditional, of any plan or any authority, conditional or unconditional, to accept any plan . . . until after the entry of the order approving such plan and the transmittal thereof to the creditors and stockholders. . . ."

The act permits the court to approve compensation to members of a protective committee out of the estate and also reimburse them for any proper expenses incurred. However, this can be done only if they have contributed something worth while and something constructive. The exact wording of the act is as follows: "In fixing any such allowances, the judge shall give consideration only to the services which contributed to the plan confirmed or to the refusal of confirmation of a plan, or which were beneficial in the administration of the estate, and to the proper costs and expenses incidental thereto" (Chap. X, Art. XIII, sec. 243).

APPROVAL OF THE PLAN

Following the various steps and formalities outlined in the foregoing paragraphs, and after receipt of the advice of the Securities and Exchange Commission, the court may announce its approval of a plan of reorganization if it is satisfied on all points. One of the important prerequisites to approval is that the requirements covering such a plan be met. Among the fourteen points which are detailed by the act in this respect are the following (Sec. 216): (1) provision for the payment of the costs of administration; (2) provision for any class of creditors which does not accept the plan by a two-thirds majority; (3) similar accommodation of any class of stockholders which does not accept the plan by a majority; (4) prohibition of the issuance of nonvoting stock and provision for the equitable distribution of voting power; (5) requirement that the "terms, position, rights, and privileges of the several classes of securities" are "fair and equitable and in accordance with sound business and accounting practice."

ACCEPTANCE AND CONFIRMATION OF THE PLAN

After the initial approval by the judge, the plan is submitted to the creditors and stockholders, accompanied by the report of the Commis-

[28] In fact, Chapter X of the Bankruptcy Act specifically provides that "any creditor or stockholder may in a proceeding under this chapter act in person, by an attorney at law, or by a duly authorized agent or committee."

sion and the opinion of the court. Acceptance by interested parties requires approval by two thirds of the amount of claims of creditors, and if the debtor is not insolvent, approval by a majority of the stock.[29]

If the creditors who hold two thirds of the amount of the claims against the corporation and the holders of a majority of the stock of the corporation accept the plan, the minority creditors and stockholders are bound by the plan. This provision of the act definitely recognizes the "majority rule" and, as a result, seems clearly to disregard the sanctity of the contracts of the minority creditors and stockholders. The only way in which creditors and stockholders can defeat the "plan" is to try to induce a sufficient number of creditors and stockholders not to vote for the approval of the plan so that the "two-thirds and majority requirement" will not be met.

Following the acceptance, the judge is required to hold a hearing to consider any objections which may be made against the final confirmation. Ultimately, the court renders a confirmation if satisfied that "the plan is fair and equitable and feasible" and that it has been made in good faith in keeping with the provisions of the act. With this conclusion, the plan becomes binding upon all parties concerned; and a final decree is entered "discharging the debtor from all its debts and liabilities, closing the estate," and making miscellaneous clearances.

SUMMARY OF PROCEDURE

Briefly, the order of the main steps in the process of a reorganization that is finally confirmed is as follows: (1) preparation of a plan of reorganization by the trustee and its submission to the court; (2) hearing by the court to consider objections or substitute plans which may be proposed by the debtor or by any creditor or stockholder; (3) reference of the plan to the Securities and Exchange Commission by the court for advice; (4) initial approval of the plan by the court; (5) submission of the plan and related reports to the security holders for acceptance; and (6) confirmation of the plan by the court.

THE McKESSON & ROBBINS CASE

The technicalities of reorganization procedure are undoubtedly confusing to the lay investor; and like the patient in the hands of a doctor, the average investor resigns himself to the treatment. He simply waits expectantly—at times, patiently; at other times, impatiently. However, in retrospect, it is possible to review the various steps and to gain greater appreciation of what took place. A convenient illustration is the case of

---

[29] If the debtor is insolvent, the consent of the stockholders is not required to make the plan effective.

McKesson & Robbins, Inc., which failed because of management difficulties described more fully in Chapter 15.

No attempt is made here to report each and every development during the course of reorganization proceedings but there is sufficient reporting of the chronological steps to provide a sense of continuity.[30]

December 5, 1938—Charging waste and mismanagement, Vincent W. Dennis, a common stockholder, filed an equity receivership action in the United States District Court at Hartford, Connecticut, against the company.

December 8, 1938—W. J. Wardell, an attorney, and Charles F. Michaels, executive vice-president, were named trustees by Federal Judge Alfred C. Coxe of the Southern District of New York, under Chapter X of the Chandler Act. The petition was filed pursuant to a resolution adopted by the board of directors of the company. This action superseded that of a stockholder who had an equity receiver appointed at Hartford, Connecticut.

December 9, 1938—A preferred stockholders' committee was formed to represent the interests of the $3.00 cumulative, convertible preference stock. A protective committee was formed for the holders of the common stock. A protective committee was formed by the holders of the twenty-year, 5½ per cent convertible debentures, due on May 1, 1950.

A merchandise creditors' committee was formed after a meeting of the members of the several credit groups of the New York Credit Men's Association.

December 19, 1938—Charles F. Michaels withdrew as additional trustee because of a possible conflict of interest. He was immediately appointed by Mr. Wardell, the remaining trustee, as chief executive assistant in charge of operations, and was elected president of the company on December 20.

May 13, 1939—Mr. Wardell, trustee, filed in the New York Federal Court and mailed to stockholders and creditors his second report on results of the audit of the company's books. It disclosed the concern to be on the road to full recovery from the effects of the fraud perpetrated by F. Donald Coster, a former president.

November 27, 1939—The trustee mailed to security holders and creditors a special report laying the groundwork for the preparation of a reorganization plan for the company. As a guide to those who wished to submit recommendations, the trustee outlined various possible methods of reorganization.

November 7, 1940—The trustee submitted a reorganization plan to the federal court.

November 23, 1940—Judge Coxe signed an order setting December 20 as the date for the first hearing on the plan, at which time objections, amendments, or new plans might be offered.

December 7, 1940—The protective committee for the holders of debentures indicated opposition to the reorganization plan, arguing that the case was one of financing rather than reorganization.

December 20, 1940—The protective committee of preference stockholders filed objections to the plan. It asserted that the trustee had drawn up a plan so that the company could "withstand uncertainties of the future" and, in so doing, had destroyed priorities and contractual rights of preference stockholders.

February 20, 1941—Judge Coxe sent an amended plan, submitted to him by the

[30] In each instance, the source of the information is the *Commercial and Financial Chronicle*.

trustee, to the Securities and Exchange Commission. The trustee stated that the amended plan had the approval of the protective committees.

March 25, 1941—The Commission filed with the court an advisory report recommending that the trustee's plan of reorganization be approved.

March 31, 1941—The amended plan was approved by the court, which ordered the trustee to submit it to a vote of creditors and stockholders.

May 12, 1941—The trustee submitted to the court evidence that the security holders and creditors had registered, by overwhelming votes, approval of the plan. Over 97 per cent of the stockholders and creditors of all classes were in favor of the plan.

June 12, 1941—Judge Coxe signed an order approving the form of agreement to be used in underwriting new securities.

June 21, 1941—The company filed with the Commission registration statements for the new securities.

June 30, 1941—The trustee declared the reorganization plan to be effective, as new securities had been offered to the public and the property of the company (with certain exceptions) had been transferred from the trustee to the company on July 1, 1941, pursuant to a court order dated June 30.

REORGANIZATION OF PUBLIC-UTILITY COMPANIES

As stated previously, all the features of the reorganization of industrial companies apply also to public-utility organizations. However, in addition, it is provided that plans of reorganization must be referred to the commissions having "regulatory jurisdiction over the debtor." In case the public-utility company is wholly intrastate, it is required that the state commission shall certify as to the fairness of the plan. However, to guard against unnecessary delay, the court is authorized to proceed if action is not obtained within thirty days, or whatever period of time the court may prescribe.

QUESTIONS AND PROBLEMS

1. Why are "delay and controversy . . . virtually inherent in the process of reorganization"?
2. Discuss the possible effects or influences of economic conditions on plans of reorganization.
3. Why is it essential that adequate opportunities be provided for hearings of plans of reorganization? Do you think security holders are in a position to attack such hearings?
4. Discuss the difficulties of establishing "good faith" in the filing of applications under Chapter X of the Bankruptcy Act.
5. In your opinion, is it possible to have a condition of absolute "disinterestedness"?
6. Do you believe the Securities and Exchange Commission can be a truly "disinterested" advisor, or does it reflect a philosophical viewpoint?
7. Do you believe that existing management is deserving of special consideration by virtue of its previous service?
8. What is your answer to the question raised on page 672: "If personal interest can be relied upon as a motivating force for the conduct of normal

business operations, why may it not also be used in the case of reorganization?"

9. Do you believe that the advisory duties of the Securities and Exchange Commission are in conflict with the independence of judicial process?
10. Discuss the problem of valuation of property during a period of reorganization.
11. Analyze the plan of reorganization of any company of your choosing, and discuss the plan as to its feasibility and fairness. You may choose a major company from those listed in the annual reports of the Securities and Exchange Commission or one under the jurisdiction of your Federal District Court.
12. As a matter of public interest, should the burden of proof rest on the side of liquidation or on the side of reorganization in the case of a company that has failed?
13. What are some of the principal objections to the reorganization of corporations through equitable receivership? In what respects has reorganization under the Bankruptcy Act, as amended, removed some of these objections?

REFERENCES

BRADLEY, JOSEPH H. *Fundamentals of Corporation Finance*, chaps. xxxi, xxxii. New York: Rinehart & Co., 1959.

BUCHANAN N. S. *The Economics of Corporate Enterprise*, chaps. xiii, xiv. New York: Henry Holt & Co., Inc., 1940.

DEWING, A. S. *Financial Policy of Corporations*, chaps. xxxix–xliii. New York: The Ronald Press Co., 1953.

GERDES, JOHN. *Corporate Reorganization under Section 77B of the Bankruptcy Act.* Chicago: Callaghan & Co., 1936.

———. "Corporate Reorganization: Changes Effected by Chapter X of the Bankruptcy Act." *Harvard Law Review*, Vol. LII (1938), pp. 1–39.

GERSTENBERG, CHARLES W. *Financial Organization and Management*, chap. xxiv. 4th rev. ed. Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1959.

GUTHMANN, H. G. and DOUGALL, H. E. *Corporate Financial Policy*, chap. xxx. Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1955.

OSBORN, RICHARDS C. *Corporation Finance*, chap. xxv. New York: Harper & Brothers, 1959.

Chapter 33 ►

REORGANIZATION PROCEDURE—*Continued*

ONE OF THE features of the broad reform in the thirties of bankruptcy and reorganization proceedings was the development of specialized treatment for different areas of activity. Consistent with this pattern, the railroads were placed in a separate category. Initially, there was little fundamental variance from the procedure devised for industrial and public-utility companies; but the sweeping amendments of the Bankruptcy Act in 1938 made the distinctions real and effective. There is undoubtedly good argument for specialized reorganization procedure as a means of recognizing the peculiarities of each field of enterprise. At the same time, the present classification, which places industrial and public-utility companies in one group and the railroads in another group, is not entirely sound.

Basically, the operations of public utilities have more in common with the railroads than they have with the motley collection of companies that comprise the industrial group. The public service of public utilities and railroads is of such a nature that the quality of such service and its cost to the public are little affected by competition among the suppliers of such services. They are "natural" monopolies and, as the court has said, "are affected with a public interest." Because of this inherent nature, public utilities and railroads are formally regulated by agencies of the state and federal governments, e.g., state public service commissions and the Interstate Commerce Commission. On the other hand, the activities of industrial companies are presumed to be subject to the corrective influences of competition; consequently, there is less regulation of their operations. It would seem, therefore, that the present classification under the national Bankruptcy Act, as amended, is more the result of areas of regulation and historical development than one of industry characteristics; in short, the line of cleavage reflects primarily the respective authorities of the Interstate Commerce Commission and the Securities and Exchange Commission.

RELATIONSHIP BETWEEN REGULATION AND REORGANIZATION

In observing the possible connection between regulation and reorganization, attention may first be directed to the influences of the former upon business operation. Regulation is generally recognized as being necessary in certain fields of enterprise to protect both the interests of individual consumers and the interests of the public as a whole. At the same time, fairness compels the recognition of the responsibilities that arise by the exercise of this function, instead of accepting it simply as an outright privilege of the power of sovereignty.

By being held partly responsible for the results of operation, regulatory authorities should, in turn, be charged with some of the responsibility for failure. Consider, for example, the fact that both the public utilities and the railroads may not issue securities solely of their own choosing; instead, there is need for approval by the proper regulatory bodies. The approval of security issues by the latter is not tantamount to a guarantee; but, certainly, it implies some sharing in the final responsibility for the results. Particularly is this true when the important rate schedules, with their large influence upon the gross income account, are also under supervision and regulation. Under these conditions, failure may not always be directly chargeable to private management alone.

Since the reorganization procedure established under Chapter X of the Bankruptcy Act lays great stress on the need for disinterestedness in the formulation of a plan of reorganization, the question is pertinent as to whether or not the principle applies equally to all fields of enterprise. Thus, there already exist marked limitations on the promotion of personal interest in the normal operations of railroads and public utilities. What, then, is the occasion for introducing further disinterestedness at the time of failure? In the case of industrials, the setting is different because it is openly assumed that personal interest is one of the primary forces motivating this form of enterprise. Hence, when industrial companies fail, there may be greater need for disinterestedness than in the case of railroads and public utilities under similar conditions of distress. Moreover, the latter two groups are subject to continuing regulation after reorganization; whereas industrial companies revert to a status of relatively free operation. Irrespective of these questions of theoretical interest, the fact remains that the reorganization of public-utility companies is now being processed in about the same manner as industrial corporations.

BASIC PRINCIPLES OF RAILROAD REORGANIZATION PROCEDURE

Chapter VIII of the Bankruptcy Act, approved on March 3, 1933, and later amended as of August 27, 1935, provides for the reorganization of railroads. It is usually referred to as Section 77, and this designation will be used here. It established the basic procedure for the reorganization of

those railroads requiring comprehensive overhauling of their financial structures.[1]

The provisions of Section 77 show in many ways the reactions to the extreme depression of the early thirties and the perilous plight of the railroads. There is little reflection of either the philosophy of, or concern for, the protection of independent investors which is found in Chapter X of the Bankruptcy Act covering the reorganization of public-utility and industrial companies. On the contrary, Section 77 places emphasis on relief for the debtor at the expense of familiar rights and privileges of investors. Such favoritism of the debtor has already been restricted by the courts in preserving the rights of priority, but the independence of a minority position has largely been nullified.

Section 77 applies only to railroads; but companion legislation, which constituted Section 77B of the Bankruptcy Act, was passed in 1934 to apply to industrial and public-utility companies. The latter is no longer effective, being replaced by Chapter X of the Bankruptcy Act, discussed in the preceding chapter. However, Sections 77 and 77B were similar in their essential provisions; and the present analysis of Section 77, which is in current use for railroads, may be of value also as a commentary upon a previous phase of reorganization practice covering the industrials and public utilities.

Filing of Petition. "Any railroad corporation may file a petition stating that it is insolvent or unable to meet its debts as they mature and that it desires to effect a plan of reorganization." Action may also be initiated by the creditors by filing an involuntary petition if their claims are equal to 5 per cent or more of the total indebtedness of the corporation. The petition is addressed to the proper federal district court (this court being the one whose territory includes the city where the principal offices of the company are located), and the judge will approve the request if he is convinced that it is properly filed and in good faith; otherwise, he will dismiss it. The debtor may file an answer to an involuntary petition, and any creditor may answer. The party filing has the burden of establishing the material averments and good faith in a summary hearing by the judge without a jury.[2]

If the action is approved, the law specifies that the railroad will be referred to as a "debtor." Such a label is more appropriate for purposes of reorganization and does not carry the stigma that usually adheres to desig-

---

[1] In 1939, the act was again amended by adding Chapter XV. This chapter was passed as a temporary measure and was designed to provide relief for less serious cases. Recourse to the procedure provided by Chapter XV was confined to railroads that had not undergone reorganization under Section 77 or had not been in equity receivership for a period of ten years prior to the filing of the application.

Chapter XV, as provided for in 1939, terminated on July 31, 1940. It was substantially re-enacted in 1942 and was allowed to lapse on November 1, 1945, by failure of re-enactment.

[2] U.S. Code, Title 11, *Bankruptcies*, Sec. 205 (*a*).

nation as a "bankrupt." It also reflects the leveling influence of the depression which so significantly narrowed the margin between the state of failure and that of a going concern. The debtor remains in possession of the property until a trustee is appointed.

Appointment of Trustee. If the petition is approved, the debtor is required to give proper notice to the creditors, stockholders, and other interested parties. Opportunity is then given for a hearing on the part of any of these groups; and, if no objection develops, the court proceeds to appoint a trustee, who must be confirmed by the Interstate Commerce Commission. Except where the annual operating revenue is less than $1,000,000, the judge is required to appoint one or more additional independent trustees if the initial appointee has been in the employ of the company during the preceding year. To discourage unwarranted domination by inside interests in the appointment of trustees, the Interstate Commerce Commission may, at its discretion. hold formal hearings where all of the various parties may express their opinion of the trustees selected.

Further extension of the control of the court in approving personnel for handling reorganization is provided by giving the judge authority to sanction the selection of legal counsel. The statute declares that the "judge shall in his discretion confirm the appointment of such legal counsel for the trustees as they shall select, with powers of removal." Obviously, the "powers of removal" give the court continuous check upon the service rendered and reduce to a minimum the dangers of abuse of office for personal or other reasons of favoritism.

The desire to remove undue influence of insiders is readily apparent in the foregoing requirements. Thus, an additional trustee is required when the initial appointee had a recent connection with the debtor; and legal counsel may be subject to confirmation by the judge. There are lacking, however, the ironclad tests of disinterestedness which were established in Chapter X of the Bankruptcy Act; and the primary responsibility for the preparation of the plan of reorganization is not placed in the trustee. Likewise, there is no exclusion of underwriters or other financial interests, as was true of the more stringent Chapter X reorganization procedure. Indeed, as shown in a following section, the power to initiate and promote plans of reorganization is greatly extended.

The trustees are given the right to operate the debtor's property and, in general, have all of the rights of a receiver in equity. This means that the trustees are usually given the authority necessary to issue certificates of indebtedness for the purpose of raising funds, acquiring property, etc. The certificates may also have the priority of claim which may be accorded receivers' certificates. In brief, the trustees serve in the capacity of operating managers and not as reorganizers.

Plan of Reorganization. The purposes of the plan of reorganization are similar to those sought in earlier equity receivership proceedings, viz., to provide for the reduction of fixed charges, adjustment of principal in-

debtedness, raising of new capital, etc. Procedure differs, however, in the possible sponsorship of a plan and in the time required for filing. With reference to the latter feature, the law specifies that a plan of reorganization must be filed by the debtor within six months after the date of the court order approving the original petition, unless the judge has granted an extension for "cause shown." The extension may not be for more than six months, but the request for postponement may be repeated. The act further provides that "such plan shall also be filed with the Interstate Commerce Commission at the same time."

The time limitation is undoubtedly intended to speed up the process of reorganization, but experience to date shows extension to be the rule. This is caused by the tortuous character of rehabilitation and the difficulties of consolidating the interests of many diverse groups. Illustrative of the wide distribution of representation, the Chicago, Rock Island & Pacific Railroad Company, whose reorganization was completed in January, 1948,[3] was reported to have had seventy-two different classes of creditors and security owners.[4] Even so, the imposition of a requirement covering the length of the reorganization period may be desirable as a means of preventing unwarranted delay.

Although the power to limit the length of proceedings is desirable, it is not so easily put into practice. Railroads, more than either industrials or public utilities, have a much greater variety of lien positions; and their operations are more readily divisible into separate units. As a result, there may be many conflicts of interest which may easily lead to a first-class example of a business jigsaw puzzle whose solution calls for both time and diplomacy. Illustrative of the difficulties that may develop, the following incidents occurring during a short phase (all in the last half of 1935) of the reorganization of the Chicago, Rock Island & Pacific Railroad Company may be noted:

August 7—Federal Judge Wilkerson of Chicago ordered the company to show cause why it should not be required to present a plan of reorganization by September 17.

August 30—Preferred stockholders' committee filed a proposed plan of reorganization.

September 21—Judge Wilkerson took under advisement the request of debtor's attorneys for an extension of six months to February 27, 1936, in which to file a reorganization plan.

Counsel for the Reconstruction Finance Corporation and attorneys for banks with loans against the debtor did not object to the request but asked that the order be made conditional.

October (various dates)—Trustees of debtor asked Interstate Commerce Commission for authority to abandon certain branch lines.

November 16—Report made to Commission that 122,527 shares, or 42.3 per cent of the company's 7 per cent preferred stock, and 94,840 shares, or

[3] *Wall Street Journal*, January 2, 1948, p. 14.

[4] *Commercial and Financial Chronicle*, July 20, 1935, p. 365.

37.6 per cent of the 6 per cent preferred, had deposited holdings with the committee headed by Mr. Harrison.

December 4—Protest filed with Commission by Waterbury Savings Bank of Waterbury, Connecticut, against treatment of consolidated mortgage 6 per cent bonds as proposed in company plan.

December 10—Interstate Commerce Commission rejected preferred stockholder's plan, declaring it to be "*prima facie* impracticable."

The foregoing presentation is by no means a complete summary of events; but it does indicate the chaos, strife, and confusion that arise in the reorganization of the company. With such a setting, it is little wonder that a rather extended period of time is required to effect the reorganization of a company.

As stated above, another departure from previous practice is to be found in the sponsorship of plans of reorganization. Previously, the plan usually emanated from a specialized reorganization committee. But the present law makes the following provisions: (1) a plan may be proposed by the trustee; (2) plans may be submitted on behalf of not less than 10 per cent of the amount of any class of creditors or stockholders; (3) the Interstate Commerce Commission itself shall approve a plan that may or may not be the same as any recommended.

Such features as the foregoing reflect in marked fashion the substitution of equity for legal right and of public policy for individual or group welfare. For example, one would normally expect the stockholders to have little voice in time of reorganization. In terms of property rights, the stockholders' investment frequently vanishes with failure; and to encourage this group to submit a plan of reorganization is distinctly a matter of equity. In turn, the requirement that the Interstate Commerce Commission shall formally announce a plan of its own is undoubtedly intended to introduce the element of public welfare. To quote from the law on this matter: "The Commission shall render a report and order in which it shall approve a plan, which may be different from any which has been proposed . . . and will be compatible with the public interest."

Confirmation of Plan of Reorganization. Upon approval of a plan by the Interstate Commerce Commission, it is so certified and presented to the court. The latter gives proper notice to the interested parties and affords the opportunity to file any objections. If a hearing proves necessary, the court will give due consideration to the arguments of the opposition, after which the plan may be given final approval if the court is satisfied that (1) provision is made to eliminate the previous causes of failure without unfair infringement upon the rights of the various classes of claimants; (2) there is full disclosure of the costs and expenses of reorganization, as well as the amounts to be paid by the debtor corporation or other corporations which may acquire the assets of the debtor; and (3) provision is made for the payment or disposal of the costs stipulated in (2).

After court approval, a certified copy of the order and opinion is sent

to the Interstate Commerce Commission, which proceeds to notify all interested parties in order that they may express their acceptance or rejection. Subject to the consent of the court, the Commission has the power to omit the approval of any class of stockholders under the following conditions: (1) if the corporation is insolvent at the time of the finding or if the equity of the stockholders has no value; (2) if the stockholders will not be adversely or vitally affected by the plan; (3) if the debtor has, pursuant to authorized corporation action, accepted the plan and its stockholders are bound by such acceptance.[5]

Similar authority is given the Interstate Commerce Commission in the treatment of creditors, although the occasion for its use would be less likely in this instance. Assuming notification, all classes of claimants are required to express their acceptance or rejection in writing; and the Commission will then report the results to the court.

Finally, the court announces its confirmation of the plan, "if satisfied that it has been accepted by or on behalf of creditors of each class . . . holding more than two-thirds in amount of the total of the allowed claims" plus a similar vote of approval from the stockholding classes. In the event that these terms of approval are not met, the court has the power to declare the plan operative if it is of the opinion that the plan is fair and provides for the equitable treatment of the various claimants. Specifically, the law declares:

> Upon confirmation by the judge, the provisions of the plan and of the order of confirmation shall, subject to the right of judicial review, be binding upon the debtor, all stockholders thereof, including those who have not, as well as those who have, accepted it, and all creditors, secured or unsecured, whether or not adversely affected by the plan, and whether or not their claims shall have been filed, and, if filed, whether or not approved, including creditors who have not, as well as those who have, accepted it.

OTHER FEATURES OF THE LAW

There are numerous other provisions set forth in the law, but the foregoing are the more important ones which affect corporate financing. The other sections deal with such matters as treatment of damage claims, staying of pending suits, power of trustees or the court to affect wages and working conditions, penalties for violation of the law, etc. However, there are a few pertinent points which may be presented in summarized form:

1. The court may require the trustees to keep records and accounts that would allow the presentation of earnings and expenses according to various parts or divisions of the property. Such knowledge would allow more intelligent treatment of secured creditors, lessors of property, etc.
2. If there is undue delay in effecting reorganization, the judge may dismiss the proceedings.

[5] U.S. Code, Title 11, *Bankruptcies*, Sec. 205(*e*).

3. If it is necessary to determine the value of any property, the law states that this shall be the duty of the Interstate Commerce Commission and that proper consideration shall be given to "the earning power of the property, past, present and prospective, and all other relevant facts."

4. Solicitation of proxies and of the right in general to represent stockholders and creditors may be engaged in only with the approval of the Interstate Commerce Commission. It is not intended that this shall deny any claimant his right to protect his own interests, and groups of up to twenty-five individual holders may function without interference.

THE PURPOSE OF REORGANIZATION

With the foregoing discussion of reorganization proceedings in mind, it is important to stress that their importance is not to be found in their technique. The intricacy of legal arrangement easily gives the impression that it is the final objective; but, actually, the real purpose of reorganization is to restore to a sound condition a company that has failed. In effecting this transformation, it is important that due regard be given to the rights of the interested parties; but the desire to avoid loss by investors should not be permitted to interfere with the sacrifices that are necessary to bring about sound reconstruction. The nature of these sacrifices and the general effects of reorganization may be seen to advantage by their application to a specific case.

THE CHICAGO GREAT WESTERN RAILWAY COMPANY

So many railroads have been in receivership or bankruptcy, and particularly in the thirties, that it is not difficult to find one for purposes of illustration. Most railroads have complex financial structures and call for so much individual analysis that attention is easily diverted from the more important basic principles. Since the capital structure of the Chicago Great Western Railway Company is relatively simple, it may be selected as a convenient example.

The Chicago Great Western Railway Company operates about 1,500 miles of road, its chief terminals being Chicago, St. Paul, Minneapolis, Kansas City, and Omaha. Its traffic is mainly agricultural, and it is not surprising that the severe depression of agriculture during the early thirties resulted in a serious contraction of the road's income. This is plainly evident in the following summary of the trend of gross revenue during the depression years:

Year	*Gross Revenue*
1929	$25,825,000
1930	22,830,000
1931	20,107,000
1932	15,159,000
1933	14,575,000
1934	15,491,000
1935	15,616,000

The railroad was taken over by the courts early in 1935, and more than five years were required to complete the reorganization.[6] Thus, despite the period of six months which is prescribed by Section 77 unless further extensions are approved by court, an extended period of time was required for rehabilitation—a condition that is particularly noteworthy because of the comparatively simple capitalization of the company. The

TABLE 68

OLD CAPITALIZATION AND DISPOSITION UNDER PLAN OF REORGANIZATION

Amount of Old Capitalization	*Type of Security and Disposition under Plan of Reorganization*	*Amount of New Capitalization*
$ 2,852,325	Equipment trust certificates—no change effected	$ 2,852,325
500,000	Wisconsin Central-Minn. Term. first 3½'s, 1950—no change effected	500,000
35,544,000	First-mortgage 4's, 1959—to be exchanged for:*	
	New first mortgage 4's, 1988	10,159,660
	New general mortgage income 4½'s, 2038 (interest cumulative to 13½ per cent if earned or not)	6,095,796
	New 5 per cent preferred stock (par $50)	18,287,388
	New common stock (par $50)	6,078,022
1,288,162	Reconstruction Finance Corporation loan—a new loan of $6,396,870 is obtained from the RFC to provide for cash needs as well as to absorb the outstanding loan. Therefore, an RFC loan will appear in the new capitalization	6,396,870
1,093,885	Railroad Credit Corporation loan—to be paid in cash in full	....
46,073,500	Cumulative 4 per cent preferred stock (par $100)—to be exchanged on the basis of one old share for one-half share new 5 per cent preferred (par $50)* (cumulative after January 1, 1941, to 15 per cent)	11,536,149
45,209,400	Common stock (par $100)—to be eliminated	....
$132,561,272	Total Capitalization	$61,906,210

* There may be slight variations from these amounts, but in no instance does it exceed $55,000.

latter is reflected in the statement in Table 68, showing the old capital structure as well as the treatment of the various classes of creditors and stockholders.[7]

ANALYSIS OF CHICAGO GREAT WESTERN REORGANIZATION PLAN

It will be seen from the brief summary of the treatment of security holders in Table 68 that the capitalization of the Chicago Great Western

[6] The plan of reorganization was confirmed by the Federal District Court on March 26, 1940. *Moody's Manual of Railroads, 1940*, p. 491.

[7] Based upon a summary analysis of the reorganization as presented in Arthur Jansen, "Chicago Great Western Reorganization Nears End," *Barron's*, January 20, 1941, p. 18; and *Commercial and Financial Chronicle*, August 20, 1938, p. 1187.

Railway Company is reduced virtually by one half. The qualitative changes are even more significant and are indicated by such features as the following:

1. The plan reduces interest-bearing obligations from more than $40,000,000 to a figure slightly under $20,000,000.
2. As a result of debt reduction, the drain of fixed charges on income is materially lessened. Under the old capitalization, the fixed annual charges were about $1,900,000; these are reduced to approximately $875,000 under the new setup. Included in the latter is roughly $275,000 applicable to the general mortgage income bonds which is contingent upon earnings.
3. Additional safeguards to protect the future financial position are found in the requirements set up in the plan of reorganization to establish the following fund accounts:
   a) A sinking fund is to be created at the rate of ½ of one per cent of first-mortgage bonds for the retirement of these bonds. The charge is imposed after the payment of fixed charges and may be imposed only if the net income is available.
   b) A sinking fund with similar provisions is provided for the retirement of the general mortgage bonds at the rate of ¼ of one per cent per year.
   c) A capital fund for the purpose of facilitating the purchase of equipment and for other property improvements is provided by an annual charge equal to 2½ per cent of the annual operating revenue. This charge has priority over the interest on the general mortgage income bonds; but when the fund accumulates to $1,500,000, allocations thereafter are necessary only to keep the fund at this figure.
4. All unsecured claims arising on or prior to February 28, 1935 (designated by the court as Class 14), were left to the reorganized company for whatever disposition it saw fit but without any priority because of the reorganization proceedings.

Both the preferred and common stocks have equal share voting rights, which means that the old first-mortgage bondholders would have control of the new company. In view of the heavy sacrifices imposed on these bondholders, the assumption of control by this group is undoubtedly justified. As shown in Table 68, the old common stockholders were completely eliminated because their equity had vanished; whereas the preferred stockholders were given some hope of future recovery by exchanging one old share of $100 stock for one-half share of new stock with a par of $50. However, even such drastic reorganization left the company with sizable risk, a fact that was still reflected in the prices of its several securities more than ten years after the reorganization, and possibly still casts its shadow upon the current scene.[8]

[8] Prices of securities of Chicago Great Western as of dates indicated:

	June 25, 1951	*June 22, 1956*	*December 22, 1961*
First-mortgage 4's of 1988	86	92	71
General mortgage income 4½'s of 2038	78	85	64⅛
5 per cent preferred stock	33½	40¼	34⅜
Common stock	19	47⅝	22

To generalize on the basis of the facts presented in this case, it must be clear that the rehabilitation of a company may not be accomplished solely by revamping of the financial structure. In the background is the question of whether the physical plant and management capacity can generate sufficient earning power to make the company self-sufficient. Needless to say, there is also ever present the larger controlling influence of the state of general business conditions.

PRIORITY OF POSITION OF SECURITY HOLDERS

The foregoing case shows clearly the severe losses which investors may suffer as a result of failure and reorganization. These sacrifices invite sympathetic consideration of the plight of the investor, but they should not be permitted to interfere with genuine and thorough reorganization of a company that has failed. Vigorous pruning of the old setup is usually necessary to restore soundness of financial position and, in the long run, is likely to prove more satisfactory to the investor. The main questions are the extent of the sacrifice and the distribution of the burden among the various classes of security holders. Since these incidents of reorganization are common to all fields of enterprise, the following discussion is also applicable to industrial and public-utility companies.

Broadly speaking, security holders are treated according to their position of priority and are obviously affected by the value of the property. This means that secured creditors must be satisfied first, after which recognition is given in order to the unsecured creditors, the preferred stockholders, and the common stockholders. When there is insufficient value to indicate any real equity of the common stock, it may be completely eliminated, as was done in the case of the Chicago Great Western Railway Company.

That claims should be rated according to their priority of lien or position of claim is a simple statement, but it is not as easily put into operation. Bond issues are not always readily put into airtight compartments; instead, there may be much overlapping and interdependency. Especially is this true of the railroads, as may be seen in the following complexity of lien of the first gold 4's of 1950 of the Seaboard Air Line Railroad Company:[9]

First lien (subject to receivers' certificates) on 243.7 miles as follows:

	Miles
Acca, Va., to Norlina, N.C.	103.22
Hamlet, N.C., to Columbia, S.C.	108.10
Franklinton, N.C., to Louisburg, N.C.	9.79
Moncure, N.C., to Pittsboro, N.C.	11.45
Belt Junction, Ga. to Howells, Ga.	8.39
So. Richmond, Va., jct. to freight station	1.96
Petersburg, Va. (Dunlop St. to Market St.)	0.72
Bellwood, Va. (conn. with P. G. & Co. Ry.)	0.07

[9] *Moody's Manual of Railroads, 1939*, p. 1083.

Second lien (subject to receivers' certificates) on 1,656.22 miles as follows:
On the 273.53 miles, following $3,000,000 Carolina Central first consolidated 4's of 1949; on the 399.96 miles, following $6,085,000 Georgia and Alabama first consolidated 5's of 1945; on the 266.32 miles, following $5,360,000 Georgia, Carolina, and Northern first 6's of 1934; on the 97.11 miles, following $1,000,000 Raleigh and Augusta Air Line 5's of 1931; on the 98.35 miles, following $1,200,000 Raleigh and Gaston first 5's of 1947; on the 136.13 miles, following $2,033,000 South Bound R.R. first 5's of 1941; on the 227.80 miles, following $4,372,000 Florida Central and Peninsula R.R. first consolidated 5's of 1943; on 32.55 miles following $260,000 Roanoke and Far River first 6's, due 1917 (all pledged); on 42.02 miles following $150,000 Durham and Northern Railway first 6's, due 1928 (all pledged); and on 82.45 miles following $2,500,000 Seaboard and Roanoke R.R. Company first extended 5's, due 1931.

Third lien (subject to receivers' certificates) on 534.33 miles following $4,372,000 Florida Central and Peninsula R.R. first consolidated 5's of 1943.

Additionally secured by pledge (subject in some cases to lien of Receivers' Certificates) by other securities.

To the extent, however, that priority of lien may be determined, its importance cannot be denied. One case is known where a first-mortgage bond on the main line of a railroad went through three separate reorganizations without being affected in its position.[10]

The financial structure of industrial companies is seldom as complex as that of railroads, but the principle of priority of claim is equally applicable. This may be illustrated by the treatment of the security holders of the Studebaker Corporation of America and its subsidiary, the Rockne Corporation, which failed in 1933. Under the ensuing reorganization, a new corporation was organized; and, in 1935, it took over the assets of the original companies except the investment of the old Studebaker Corporation in the stock of the White Motor Company. The reorganization plan made the following arrangements:

Creditors of Studebaker received, for each $100 in principal amount of claims and interest allowed, 2.64 shares of White stock, 4 shares of common stock in the new company, and the right to purchase debentures[11] and additional stock. Creditors of Rockne received, for each $100 principal and interest, $25 in cash, $50 in debentures, seven tenths of a share of White stock, one share of new common, and the right to subscribe to debentures and stock.

Preferred stockholders received, for each share held, 1¼ shares of new common and the right to subscribe for a unit consisting of $15 in debentures and two and two ninths shares of common for $15 cash.

Common stockholders received, for each share held, only the right to subscribe for a unit consisting of $2.25 in debentures and one third of a share of common stock for $2.25 cash. Creditors could subscribe on the same basis for such additional units as were not taken by the old common stockholders.

---

[10] New York and Erie Railroad 4's of 1947.

[11] The new debentures were for ten years at 6 per cent, with half the interest contingent upon earnings until January 1, 1938.

LEGAL STATUS OF PRIORITY

The treatment of security holders according to their position of priority is well established by legal sanctions.[12] Court decisions have long placed emphasis on the subordinate position of the stock equity. In the case of *Northern Pacific Railway* v. *Boyd*, the court established clearly the familiar principle that creditors' rights have priority over the capital account.[13] Again, in *Case* v. *Los Angeles Lumber Products Company, Ltd.*, the Supreme Court reiterated the usually accepted principles:[14] (1) absolute priority is given to the creditors' position; (2) stockholders are not entitled to consideration until the creditors' claims have been satisfied unless they supply new funds; (3) the priority of the creditors may not be waived, even by their own voluntary action; (4) stockholders whose equity has been destroyed by insolvency may not obtain a right of participation in reorganization by contract prior to reorganization proceedings in bankruptcy unless such participation is "fair and equitable."

In the case of the Los Angeles Lumber Products Company, Ltd., the plan of reorganization was approved by 92.81 per cent of the bondholders, 99.75 per cent of the Class A stockholders, and 90 per cent of the Class B stockholders. It also had been approved by the District Court and the Circuit Court of Appeals. Dissenting bondholders asked for a review by the Supreme Court. Taking advantage of the privilege of intervention where a question of constitutionality is involved, the office of the Solicitor General of the United States also moved in behalf of the minority bondholders. Significantly, Justice Douglas declared in the majority opinion: "Where a plan is not fair and equitable as a matter of law it cannot be approved by the Court even though the percentage of the various classes of security holders required by Section 77B (*f*) for confirmation of the plan has consented. . . . All those interested in the estate are entitled to the Court's protection."[15]

Referring to the argument that allowance should be made for various intangible values which would be contributed by the stockholders, he said: "The rigorous standards of the absolute or full priority doctrine of the Boyd case will not permit valueless junior interests to perpetuate their position in an enterprise on such ephemeral grounds."[16]

The United States Supreme Court, in its decision in the case of the *Consolidated Rock Products Co. et al.* v. *E. Blois du Bois* (1941), reaffirmed the "absolute priority" principle.[17] The Supreme Court also reaf-

[12] Securities and Exchange Commission, *Annual Report, 1946*, pp. 15 ff.

[13] 228 U.S. 482 (1913). Also see *Kansas City Terminal Ry. Co.* v. *Central Union Trust Co.*, 271 U.S. 445 (1926).

[14] 308 U.S. 106 (1939).

[15] *Ibid.*, p. 114.

[16] *Ibid.*, p. 123.

[17] 312 U.S. 510 (1941).

firmed this principle in two other cases in 1942.[18] In 1946, the Supreme Court again reaffirmed this position when it denied review to a case decided by a lower court in accordance with this principle.[19]

The foregoing decisions of the United States Supreme Court clearly establish the "absolute priority" principle in corporate reorganizations. Thus, there can be no doubt that a reorganization plan, to be acceptable, must provide full compensatory treatment of claims in the order of their legal and contractual priority.

The severity with which legal priority can be enforced is demonstrated by the reorganization of the St. Louis–San Francisco Railway Company, decided in April, 1945. This road had gone into receivership in 1933 after experiencing a marked slump in earnings available for fixed charges to an amount approximating 25 per cent of those charges. The plan finally approved by the court reduced the fixed charges from about $13,000,000 per year to $3,000,000, with a little more than $2,500,000 in charges contingent upon earnings. In doing this, only the equipment trust obligations came through untouched. The various secured bonds received new securities for each $1,000 of principal amount as follows:

Type of Bond	First-Mortgage 4's	Income 4½'s	Preferred Stock	Common Stock	Cash
Ft. Scott bonds	$733	$267	...	.....	$61.34
Prior lien, Series A	219	171	$332	$333.50	15.36
Prior lien, Series B	233	182	353	355.00	25.39
Consols, Series A	221	158	174	174.00	21.05
Consols, Series B	243	174	191	191.50	36.22

Holders of a secured bank loan received a similar allocation of securities; but the original stockholders, both preferred and common, were wiped out in their entirety.[20]

The "absolute-priority" principle appears to be firmly established in a long line of Supreme Court decisions, but the doctrine has been subject to certain criticism. It has been pointed out that the "chief weakness of the absolute priority doctrine is found in its failure to give weight to the essential difference between the liquidation and the reorganization of a business."[21] It is maintained that reorganization should be recognized as a

[18] *Ecker* v. *Western Pacific R.R. Co.*, 318 U.S. 48 (1942); and *Group Investors* v. *Chicago, Milw., St. Paul & P.R.R.*, 318 U.S. 523 (1942).

[19] *Chicago, R.I., & P. Ry. Co.* v. *Fleming, C.C.A.*, Ill. 157, 157 F. (2d) 241, certiorari denied on November 18, 1946, 67 S. Ct. 201. *Otis & Co.* v. *Securities and Exchange Com.*, 323 U.S. 624, 634 (1945); *In re Portland Elec. Power Co.*, 162 F. (2d) 618 (1947).

[20] Interstate Commerce Commission, *St. Louis–San Francisco Railway Company Reorganization*, Finance Docket No. 10008, June, 1945.

[21] Harry G. Guthmann, "Absolute Priority in Reorganization," *Columbia Law Review*, Vol. XLV (1945), pp. 738–54.

device for preserving values that arise from the expectation that the business as a going concern will exceed its liquidation value. The application of the absolute-priority principle is not criticized in the case of liquidation, but it is contended that the principle of "relative priority" would be more practical and just in the case of reorganizations. The court is dealing with a going concern when it handles a reorganization case, and the value of a going concern is largely dependent upon the earning power it is able to generate. This earning power is often dependent upon the retention of the "old" management in the reorganized corporation. However, since it is usually made up of the owners of a large proportion of the stock equity of the distressed corporation, under the absolute-priority principle they would probably be eliminated as the result of a reorganization.

There is considerable merit in the criticism that has been directed against the application of the absolute-priority principle in corporate reorganizations, but there can be no doubt that this principle has now become firmly established. On the other hand, subsequent events may result in at least a partial recognition of the relativity principle. In the Studebaker reorganization, discussed above, the preferred and common stockholders had no equity remaining; but they were permitted to buy debentures at par and receive a bonus in common stock. Later, substantial earning power developed under a new and capable management, dividends were paid, and the stock sold at new highs (38½ in 1946). This gave the stockholders who chose to make new investments a chance to recoup their prior losses in a substantial manner.

Aside from the comparative rights of the creditors and stockholders and the adequacy of the assets to cover the latter, there is also the question of compelling minority interests to accede to a plan approved by the majority. On its face, it appears to be an outright deprivation of contractual rights. But this does not necessarily mean that the law establishing this authority is unconstitutional. True, the Constitution does provide that the states may not enact laws that impair the validity of contracts; but the Congress of the United States is not so confined. For instance, in the case of *Hepburn* v. *Griswold*, the court said:

> Congress has express power to enact bankrupt laws, and we do not say that a law made in the execution of any other express power which, incidentally only, impairs the obligation of a contract can be held unconstitutional for that reason. But we think it clear that those who framed and those who adopted the Constitution intended that the spirit of this prohibition should pervade the entire body of legislation and that the justice which the Constitution was ordained to establish was not thought by them to be compatible with legislation of an opposite tendency. In other words, we cannot doubt that a law not made in pursuance of an express power, which necessarily and in its direct operation impairs the obligation of contracts is inconsistent with the spirit of the Constitution.[22]

[22] 75 U.S. 603, 639 (1870).

Moreover, much may be said in favor of the restriction of minority interests from the point of view of business expediency. Altogether too often, minority actions are instituted for the sake of personal gain at the expense of the whole; and, again, they are frequently initiated solely for nuisance purposes. Also, the law provides for hearings at various points along the reorganization process, which should offer adequate opportunity for legitimate interests to present their case.

PRESERVATION OF JUNIOR POSITION BY NEW INVESTMENT

It is apparent from the foregoing that stockholders may not preserve their interest at the expense of creditors. The participation of the former in a plan of reorganization on the basis of existing investment is wholly dependent on the value of their equity. Of course, it is not uncommon for stockholders to invest additional funds in the securities of the reorganized company; and some future recovery of past losses may be possible by this means. However, such investment is purely voluntary; and the preservation of interest is the result of new funds rather than past equity.

It should also be pointed out that claims having priority need not be settled in cash. Settlement is usually effected in terms of new securities, but it is required that the value of such securities be equal in value to the claims against the old company. If it be discovered that the claims of the creditors were not fully met, the new company may still be held liable for the old debts.[23] Nevertheless, the use of securities to settle the obligations of the old company makes it easier for junior interests to participate because of the difference between values established for a going concern and those established for purposes of cash liquidation. Also, reorganization managers seek to retain the old stockholders both as a means of retaining their support and as a means of seeking new cash by the sale of securities of the reorganized company.

VOLUNTARY REORGANIZATION

In April, 1948, the President signed the so-called "Mahaffie Act,"[24] providing for voluntary reorganization of railroads to avoid prospective financial difficulties, inability to meet maturing debts, or impending insolvency. A railroad can usually foresee impending financial troubles, and security holders are ordinarily aware of them. Often, the security holders would be willing to make some modifications in their agreement with the company in the hope of avoiding a costly reorganization under Section 77.

Under the Mahaffie Act, a railroad may propose modifications of the

[23] *Northern Pacific Ry.* v. *Boyd,* 228 U.S. 482 (1913).

[24] P.L. 478, 80th Cong., amending the Interstate Commerce Act. U.S.C. Title 49, Sec. 20 b.

terms of outstanding securities and make application to the Interstate Commerce Commission for a hearing on the proposal. If the Commission finds that the proposed modification (1) is within Section 20 (*b*) of the Interstate Commerce Act; (2) will be in the public interest; (3) will be in the best interest of the carrier, of each class of stockholders, and of the holders of each class of obligation affected by such modification; and (4) will not be adverse to the interests of any creditor not affected by the proposed modification, it will order the proposal submitted to the holders of each class of securities affected. All letters, advertisements, or other communications, and all financial statements used by the railroad in submitting its proposal to the securities holders, must be approved by the Commission for accuracy and completeness. If the modification is approved by holders of more than 75 per cent of the aggregate principal,[25] the Commission will enter an order making the modification effective. Any person adversely affected has the same rights of judicial review as under any other order of the Interstate Commerce Commission. The act also made the foregoing procedure available to railroads in receivership or Section 77 reorganizations, with the approval of the judge in charge.

Railroads as a class have long felt the effects of substitute competition, i.e., private autos and trucks and more recently the airlines. While rail services have remained essential in character, they have not remained profitable. This has been especially true of railroads with relatively large amounts of passenger traffic, or with low traffic density. Under authority of the Transportation Act of 1958, the Interstate Commerce Commission has the power to guarantee loans made to a railroad for capital expenditures made after January 1, 1957 or for the maintenance of property. The general purpose given was ". . . to encourage the employment of labor and to foster the preservation and development of a national transportation system adequate to meet the needs of the commerce of the United States, of the postal service, and of the national defense" (Section 501). Clearly, financial support has been substituted for the "wringer" as represented by Section 77 or Mahaffie Act reorganizations. Perhaps the time gained by the loan approach will permit a more realistic solution to the problem.

APPRAISAL OF REVISED REORGANIZATION PROCEDURE

The amendments to the federal Bankruptcy Act mark a recognition of investor and public interest, as well as an effort to streamline the process of reorganization. Without doubt, much was needed in the way of improved technique for the overhauling of distressed companies, and it

[25] Whenever 75 per cent of the principal amount is held by fewer than twenty-five holders, the Interstate Commerce Commission may require approval by a high percentage.

would appear that the intent of the legislation marks a step forward. At the same time, one cannot be unmindful of certain potential defects.

In the first place, the amendments are intended to reduce the time required for reorganization. This reduction has failed to materialize in many instances; and, of course, it does not necessarily follow that a hasty reorganization is the best way of accomplishing the task.

In addition to the time factor, there are also the direct, out-of-pocket costs which arise both from administration and other related activities of reorganization. Whether or not the Chandler Act will facilitate the reduction of such costs under conditions of widespread failure cannot be predicted with accuracy. It is true that, thus far, the related governmental agencies (the Interstate Commerce Commission, the Securities and Exchange Commission, and the now liquidated Reconstruction Finance Corporation) have advocated vigorous reduction of the burdens placed on the investors of insolvent companies; and also, they have stressed the importance of minimum fixed charges for the newly organized company. The latter may prove to be the most important saving of all, although there is the danger of some inequity to certain classes of security holders. This possible unfairness could be avoided if the plan of reorganization were constructed so as to allow for favorable developments in the future, but this is no simple matter. However, there is some indication that it may be accomplished by offering junior interest warrants which would permit future participation.

Whatever the merits of the amendments, their application has already exercised significant influence upon finance and the entire money market. Necessarily, financial practice always adjusts itself to any changes superimposed upon it by the process of the law.

QUESTIONS AND PROBLEMS

1. Discuss the merits of providing different reorganization procedure: (*a*) on the basis of the type of business and (*b*) on the basis of the size of companies.
2. Discuss the responsibilities of regulating agencies for the failure of companies under their jurisdiction.
3. Do you believe that regulation of public utilities and railroads establishes sufficient "disinterestedness" in times of normal operation to make further changes in this direction unnecessary in periods of reorganization?
4. "Compulsory participation by minority interests may be easily avoided by the sale of their securities." Discuss the nature of this alternative.
5. Compare the qualities of disinterestedness found in Section 77 with those set forth in Chapter X of the Bankruptcy Act.
6. Do you believe that parties in interest should have the right to file plans of reorganization with the court?
7. What are the dangers of changing existing legal rights in order to meet the demands of changing public interest?

8. Do you believe that common stockholders should have a voice in determining plans of reorganization?
9. Under what conditions may financial reorganization alone be insufficient to cure the causes of failure?
10. Note the large percentages voting to approve the reorganization plan of the Los Angeles Lumber Products Company, Ltd.; and indicate whether you believe such endorsement should be grounds for approval.
11. The Securities and Exchange Commission, in its *Annual Report* for 1944, stated: "In appraising the fairness of reorganization plans, the Commission has at all times taken the position that full recognition must be accorded claims in order of their legal and contractual priority." What did the Commission mean by this statement? Do you agree with the position of the Commission?
12. Analyze the plan of reorganization of the Denver and Rio Grande Railroad, and comment on its merits.

REFERENCES

(See references for Chapter 32.)

PART VIII ►

Public Policy

Chapter 34 ►

TAXATION: PUBLIC POLICY AND BUSINESS EFFECTS

IN THE EARLY days of the development of modern capitalism, business corporations were operated principally, if not entirely, with the view of maximizing profits for the owners. This objective had the advantage of putting a tremendous drive behind business activity, but results were often accomplished at sizable costs. All too frequently, it was found that dishonest and underhanded practices and exploitation of resources, both natural and human, would further the goal of maximizing immediate profits. The viewpoint was a short-run one; and, as a result, the profits position would often prove to be transitory. Still, it would appear that this narrow concept of operating standards accomplished much and had its place in the development of the present-day highly productive system.

It is no longer possible to think only in terms of the owner's interest. Modern corporations have developed to the point where the effect of their policies upon the economic and social organism is too obvious to be ignored. Criticism of the abuses has become more vocal and better organized. Consequently, it is now necessary to recognize the existence of at least three groups who have at the same time both common and diverse interests in business, namely, the investors or owners; the employees; and a third group which includes both the foregoing—the public. The last group finds expression through its various legislative leaders and their actions with respect to the regulation and taxation of business generally and corporations in particular. Most promising for the future is the growing recognition by business itself that management policies must be shaped with proper regard for the public interest. It is unimportant that business management has broadened its views partly because of public opinion and the pressure of organized groups. What is important is the growth of a public-policy viewpoint on the part of management, particularly the management of "big business." On the other hand, the levels of taxation have reached the point where it is necessary for the public to consider the effects of high taxation on business enterprise.

Throughout the foregoing chapters, the nature of public interest in relation to financial considerations has been pointed out. But to be truly effective, public interest requires formulation and direction. This may be accomplished by education or moral suasion; it may require regulatory action; or it may be attained through tax policies. Attention has already been given to the first two ways of making public policy effective; in this chapter, consideration will be given to taxation as a tool of public policy and its business effects; and public policy as such will be discussed in the following chapter.

REASONS FOR INTEREST IN TAXATION

Today, taxation is attracting wider attention and more careful study than has usually been true in the past. This is the result of a constantly increasing burden of taxation placed upon our economy through an almost continuous expansion of governmental functions. At one time, the functions of government were limited principally to the maintenance of law and order within the country and protection against foreign powers. To these should be added a limited number of services which for one reason or another were assumed by government rather than by private enterprise. Gradually, however, the duties of government have been expanded to include public roads, free public education, and more recently a host of so-called "social services" such as a system of veterans' benefits which in itself now costs more than the average yearly federal budget prior to World War II, unemployment compensation, and old-age pensions. Upon the cost of these and similar functions must be superimposed the enormous costs of a defense program geared to a global strategy of both economic and military assistance. It should not be inferred that all of the services or functions named represent added costs to the economy. Roads and schools were once furnished by private enterprisers who sold their services. Today, they are furnished by government, which levies taxes to cover the costs.

In the search for more revenue to pay for the added functions, corporations have received full attention from the legislative bodies. As corporations have grown in size and profitability, they have afforded a convenient basis for special tax treatment. This arises partly because the taxation of corporations is politically feasible and partly because of administrative convenience. It is much easier from a political viewpoint to levy taxes upon a few thousand corporations, which presumably do not vote, than upon the millions of recipients of corporate income, nearly all of whom will be more keenly aware of giving up the income they have received rather than having an equivalent amount of income withdrawn indirectly in the form of corporate taxes. Moreover, in terms of administrative feasibility, it is easier to collect taxes in substantial amounts from a comparatively few large corporations generating business income than solely from the owners of that income. To these considerations should be

added the fact that taxation is an art more than a science, and collecting taxes at different points in a flow of income or upon a variety of objects may very well achieve a higher level of tax equity (or give some promise of avoiding more serious inequity).

It will not be possible in this chapter to discuss fully the tax system applicable to incorporated business. However, the student of corporation finance should have an appreciation of the influence of taxes on private business policies and operation as well as the relationships between taxation and public policy. Some of the implications of taxation to financial policy have been discussed elsewhere. Other effects of taxation will be discussed here; but before doing so, we shall look into taxation as an instrument of public policy.

TAXATION AS AN INSTRUMENT OF PUBLIC POLICY

"The power to tax is the power to define our economic system."[1] Through taxation, it would conceivably be possible to force incorporation of all business units; and, conversely, it would be possible to make the costs of incorporating virtually prohibitive. The latter practice would undoubtedly make business as it is known today practically impossible. However, as the tax laws are drawn favoring one method of operation or type of enterprise over another, so business initiative constantly seeks the alternatives that appear to offer the greatest opportunity for profitable operation. As a consequence, those interested in or charged with the responsibility of determining public policy may use tax laws to influence materially the course of business activity. Or they may design laws that will have a minimum effect upon business life.[2]

Taxation is not usually regarded as a means of shaping the business pattern; but this must necessarily be the effect, at least to a degree. Other alternative means of governmental direction would be the more outright methods of regulation and of government ownership. Under the former, some government commission would establish rules, regulations, and the broad outlines of policy within which the regulated businesses would be expected to operate. Government ownership would furnish direct control, and there would be no question of regulation. Taxation as a regulatory device would operate through the imposition of heavy burdens upon the undesirable activities and little or no burdens upon the desired forms of practice. Presumably, taxation would not directly prohibit any practice and would therefore leave considerable areas for business initiative

---

[1] Temporary National Economic Committee, *Taxation of Corporate Enterprise* (Monograph No. 9 [Washington, D.C.: U.S. Government Printing Office, 1941]), p. xi.

[2] "In a nation faced with heavy governmental requirements it is essential that the adverse effects of taxation be held to a minimum. The crux of the fiscal policy is to raise the required revenues without unduly affecting the volume of production and the level of national income." Lewis H. Kimmel, *Taxes and Economic Incentives* (Washington, D.C.: Brookings Institution, 1950), p. 193.

and discretion to function. Policies could probably be enforced through taxation with smaller administrative personnel and fewer arbitrary decisions than would be true through direct control of commerce by regulation.

At a time when taxation is taking constantly greater proportions of the national income, it would be difficult, if not impossible, to levy taxes that would have no effect upon the direction of business enterprise. Therefore, it is important to consider carefully the influence of taxation upon business and also to consider the possibilities of using taxation directly as an instrument of public policy. The importance of taxes in business decisions increases with the burden, so that extremely onerous taxes cannot have results other than the restriction of business incentives expressed most importantly in decisions relating to the expansion of production capacity. This implies the need for definite objectives or standards of measurement toward which taxation should direct the system. There is, of course, no definite agreement on the type of system which should be developed or on the objectives of the taxes to be imposed. However, certain objectives involving corporation taxation may be presented here, not in any sense of completeness but simply to point out some of the problems that may be approached through taxation or considered in designing tax laws: (1) the active circulation of economic income; (2) limitation of monopolistic or excess profits; (3) encouragement of equity investment; and (4) directed expansion.

Obviously, no one tax could result in achieving these objectives, just as full agreement on their desirability could not be obtained. However, they may be considered in designing and administering the tax structure.

Federal taxes are best adapted to public-policy purposes because of their nationwide effects. States are severely limited in their ability to impose regulatory taxes because of interstate competition. The impact of federal taxes is so predominant that state taxes generally do little more than accent the major problem. The differences between state corporate income taxes, for example, are very slight in view of the over-all tax considerations and even less significant in view of all considerations of plant location. It is possible that state taxes might influence in some degree the location of a new plant; but it is unlikely, in view of the present levels of federal corporate taxes, that they would be a major factor in a decision to move or abandon an existing plant favored by advantages of location in connection with sources of supply, transportation, markets, and labor. The foregoing policy points may now be examined with special reference to certain federal taxes.

THE CIRCULATION OF ECONOMIC INCOME

During the decade of depression which began in 1930, the economic system was subjected to much critical analysis. One of the conclusions

reached by many analysts was that a contributory cause for this depression and preceding ones had been a lack of balance between saving and spending. The classical doctrine of balance between supply and demand was held to apply only if all the economic income was immediately spent for consumption goods or directly for investment. If, however, a considerable portion of income was withheld, then an unbalanced condition developed which, if carried far enough or complicated by other factors, would result in a depression. This viewpoint held that there had been oversaving and that much of it was the result of retention of earnings by corporations.

Failure to distribute earnings was criticized by many because often the earnings were not invested immediately and were withheld from active circulation. To a degree, there was a substitution of personal for economic motive because large and controlling stockholders sought to avoid the high surtaxes which would have been applicable upon their incomes if dividends had been paid. Instead of receiving the income, they preferred to have their ownership equity increased until such time as the funds were needed or lower taxes might prevail. At the same time, thousands of small stockholders were denied dividend income which might have been spent upon consumption goods or reinvested in other enterprises according to their judgment, with the consequent stimulation of the flow of national income.

The Undistributed Profits Tax. The undistributed profits tax, which was in effect during 1936 and 1937, represented an attempt to force distribution of corporate net income. In March, 1936, the President had asked Congress to adopt such a tax but to repeal all existing taxes on corporate income. It was believed that this would force distribution of more corporate income to stockholders where it would be spent on consumer goods or used to pay the higher individual income taxes and thus aid the government's budgetary problem. The further advantage was claimed that the taxation of undistributed profits would treat all business more equitably regardless of the form of organization.[3]

The Revenue Act of 1936 established a corporate normal tax graduated from 8 to 15 per cent and imposed an undistributed profits tax graduated from 7 per cent to 27 per cent. In other words, the law was a compromise; and the undistributed profits tax was in addition to existing taxes rather than a replacement tax as originally recommended. If a corporation paid out *all* of its net earnings remaining after paying the corporate normal tax of 8 to 15 per cent, it would have paid no undistributed profits tax. If it paid out 70 per cent of the net earnings available for dividends, the un-

[3] The income tax law does not recognize any distinction between the individual and unincorporated enterprise. The net income of personal proprietorships or the shares of partnership income are taxed under the personal income tax schedule. This amounted to 4 per cent normal tax plus a graduated surtax ranging from 4 per cent to 75 per cent in 1936.

distributed profits tax would be graduated from 7 to 17 per cent, or an average tax of 12 per cent of the income not paid out. At the other extreme, the corporation paying no dividends would have been required to pay from 7 to 27 per cent, which, owing to the brackets involved, gave an average rate of 20.5 per cent.

The objections offered by business were various. One was that the tax ignored the importance of surplus and reserves in corporate finance. It was contended that too little attention was given to financial stability and that society gained wherever the retention of earnings served to avoid failures. Another objection was that the tax did not make provision for previous deficits. If a concern had several years of operating deficits, as is frequently true, particularly of new companies, there appeared to be good argument for permitting it to retain part or all of its later income to absorb the deficits and restore the capital to its proper position. A third and widely publicized objection was the lack of recognition given to the financial problems of small corporations. Small companies must rely upon internal sources for expansion capital to a far greater degree than is true of large concerns. The latter may issue bonds in sufficient amount to be marketed efficiently, but small concerns are unable to do this. Accordingly, it was contended that the tax affected small business adversely. As a result of business opposition, the tax was extensively revised and reduced to 2½ per cent in 1938. It was repealed in 1940.

LIMITATION OF MONOPOLY OR EXCESS PROFITS

Under the capitalistic system, it is the function of profits to bring forth productive effort. Theoretically, high profits stimulate competition; and it is presumed that profits out of proportion to the effort or the risk will result in the establishment of new business units and that the increased capacity will result in lower prices and lower profits. However, it must be recognized that, in practice, competition all too often works imperfectly. Profits in excess of the amount theoretically required for maintaining activity in a line of enterprise are a common occurrence and are to be found in any size or type of business.

Excess profits are often associated with monopoly; but, in popular thought, monopoly is usually believed to be represented only by large enterprise. In reality, monopolistic profit may arise from a small enterprise which is favorably situated as far as competitive pressures are concerned. In this sense, monopoly or excess profits may exist in the eating place which has become the traditional "hangout" for the college student, just as well as in some large manufacturing concern. Because of our ability to notice big things more readily than small, there is a tendency to exaggerate the evil of the large rate of return in the big business and ignore the economic facts concerning the large rate of return in the small

business. The latter situation may occur with sufficient frequency to be quite important in the aggregate and worthy of consideration in the design of a tax directed to reach profits stemming from a continued or inherent failure of the competitive system.

Since excess profits taxes as we know them have had somewhat different objectives and have always been imposed under extraordinary conditions of defense or war programs, there is some reason to distinguish between excessive profits and excess profits. Excessive profits might be defined as being those monopoly profits resulting from the relatively permanent failure of the competitive processes, and excess profits as increased profits resulting from abnormal conditions induced by a general disruption of the prevailing normal pattern of economic and competitive operations. This distinction is not without meaning, since many efforts to recover the excessive profits of monopoly or concentrations of economic wealth are cast in the form of an excess profits tax which would make all profits excessive through the application of arbitrary standards. Such action, except under the extraordinary conditions suggested above, would truly substitute taxation for regulation as a major instrument of public policy and substitute direction for natural growth in the development of the business pattern and structure.

A further distinction may exist in the possibility that excessive profits may be taken to mean any part of or all profits exceeding an arbitrary base, justified primarily in terms of social welfare. On the other hand, excess profits have been taken to mean the increase in profits over a base determined largely in terms of the actual experience of a recent period of more or less normal economic operations.

Excess Profits Tax. For purposes of taxation, excess profits constitute the amount in excess of whatever the law arbitrarily defines as normal profits. The first excess profits tax was enacted in 1917 and was revised in 1918 before it went into effect. The 1918 law defined normal returns as 8 per cent on invested capital and levied a special tax upon all amounts in excess of this rate. The tax was 30 per cent of earnings in excess of 8 per cent but less than 20 per cent of invested capital and 65 per cent of all earnings in excess of 20 per cent of invested capital. The excess profits tax was in addition to the regular income tax which was, however, allowed as a credit before computing the excess profits.

A special war profits tax was also in effect during 1918. The war profits tax was 80 per cent of the amount above the average earnings for the years 1911 through 1913, with an adjustment allowed in the form of 10 per cent of the change in capital investment used in the business in 1918 as compared with the base period. The two taxes constituted alternative methods of computing the taxes due, and the corporation paid under the method resulting in the highest tax payment. The excess profits tax system was very productive to the government and was borne by the cor-

porations without complaint due to wartime psychology and the abnormally high returns resulting from the war boom. With the return of peace, there was a demand for its repeal; and this was finally accomplished in 1921.

The Second Revenue Act of 1940 introduced a different conception of excess profits taxation and tax rates than had existed during World War I. Under the 1940 law, excess profits were determined as the amount in excess of either 8 per cent of invested capital, plus $3,000, plus certain carry-over adjustments; or 95 per cent of the average profits for the years 1936 to 1939. Each corporation was permitted to select the basis for determining its excess profits which would result in the lowest tax payments. Corporations having a relatively large amount of capital in relation to the volume of business done favored the percentage of invested capital basis. Concerns earning a high rate of return gained by using the average earnings basis, unless earnings for the 1936 to 1939 period were unduly low.

With the return of hostilities in 1950, this time in Korea, taxes were increased sharply. The corporate rate was increased from 38 to 45 per cent and then to 47 per cent along with an excess profits tax. The excess profits tax had popular appeal; it would "take the profits out of defense," and it would tax only corporations that reputedly had enjoyed very high levels of reported profits during the postwar period, 1946–49. More substantial arguments were also made in support of the tax: it was the best device to reach "the high profits resulting from the national defense program"; it would provide a substantial portion of the extraordinary revenue needed for defense purposes; and it would be an extremely valuable anti-inflationary influence.

The protests against the tax enumerated many undesirable consequences. The more important objections were that the influence of the tax as an anti-inflationary measure was overestimated; that it would encourage managerial slackness and indifference to rising costs; and that it would dissipate economic incentives and restrict expansion. It was argued that an excess profits tax tended to maintain the *status quo;* whereas a dynamic, expanding economy was essential to our defense effort. It was also forecast that the effects of the tax would be very injurious to new and growing enterprises and to those that had introduced new basic products or services or had expanded their capacity during the base period. Finally, objection was taken to the compliance problems under the World War II version and the difficulties of obtaining relief in hardship cases.

The 1950 measure retained one outstanding feature of the World War II tax by permitting the taxpayer's choice of a credit based upon either average earnings or invested capital. However, it departed from the earlier act in three very important respects: the excess profits tax and the corporate income tax were integrated; general or "automatic" relief pro-

visions replaced the earlier ones which provided an individual-appeal basis; and a minimum credit of $25,000 was substituted for the specific exemption of $10,000. The refund credit of the earlier act, whereby 10 per cent of excess profits taxes paid was made available as a tax credit at a later date, was also eliminated.

The reintroduction of an excess profits tax raised many problems with respect to the future of corporate taxes and their effect on corporations. Among the important effects to be considered were the limiting of profits and incentives, the reduction in the dividends which are normally reinvested in business and industry, and the restriction of retained business earnings for expansion purposes. There may also have been some slackening of managerial performance.

The possibility of a permanent high profits or excess profits tax cannot be disregarded. During the postwar period, 1946–49, arguments were advanced in favor of a peacetime excess profits tax on the grounds that it would afford a means of recapturing at least part of the high profits of corporations. The more moderate proponents singled out the excessive profits of monopolies for special taxation; but the distinction and its economic meanings were easily overlooked by many advocates of a peacetime excess profits tax on corporations. Such taxation is not, unfortunately, inconceivable. To provide an alternative to the growing pressures for an all-out and uneconomic taxation of corporate income reveals anew the need for diplomacy and leadership by business in establishing firmly an economy of moderation.

THE CORPORATE INCOME TAX AND THE RESTRICTION OF INTEGRATION

If it should appear desirable to tax business according to size, that is, to discourage big business and to favor small, then the corporate income tax is a better device for this purpose than the excess profits tax. The latter should be limited to what its name implies—a tax upon excess profits. To be sure, either tax may be used to restrict the large corporation and favor the small. But certain advantages might be derived from using the excess profits tax to recapture monopoly profits and the income tax to limit size. Excessive profits arise from the imperfect functioning of competition in the economic system. At least a portion of the excess could theoretically be recaptured through taxation without any serious reduction in productive effort. Progressive corporate income taxes, on the other hand, place a restriction on the size of the business unit, since there is no necessary relationship between the amount of income and the rates of return. Thus, there are two different factors in the income situation which should receive separate treatment whenever this is indicated by considerations of public policy. Neither practice has ever been followed in any important degree, although both have been present in the tax laws at various times.

Prior to 1936, the income tax was always a proportional tax, ranging from 1 per cent in 1913 to 13¾ per cent during the 1932–35 period. The tax applied to net income remaining after the deduction of business expenses such as the costs of materials and supplies; compensation of officers; rent; repairs; bad debts; interest; taxes; contributions or gifts; losses from fire, theft, and other casualty; depreciation and depletion; and net losses for prior years. In addition, at the present time, 85 per cent of intercorporate dividends are exempt from taxation.

From 1918 to 1931, small corporations were favored with a specific credit of $2,000 or $3,000 which was granted in most tax years only to the companies with net incomes of less than $25,000. In 1936, a new system for providing relief to the small corporations was introduced. This took the form of progressive rates applying to income brackets under $25,000 and a flat maximum rate on income in excess of that amount. These graduated rates applied to all corporations showing a profit, with each company benefiting in proportion to the portion of its income falling below $25,000.

In 1938, Congress again amended the corporate income tax system and introduced a tax device which became known as the "notch" provision. The purpose of the notch provision was to give a measure of tax relief to small corporations but to deny any benefits to the larger companies. The result of this progression was to apply lower rates to the smaller companies and progressively cancel out those lower rates as net income increased up to $50,000.

This provision, which was effective until 1949, retained the progressive rates on income brackets for companies with less than $25,000 income and imposed a much higher flat rate on all income of taxpayers with incomes of $50,000 or more. The effective rate of the tax rose from 23 per cent at $25,000 to 38 per cent at $50,000 by steep graduation through the notch area using the device of still another graduated income bracket, but with a rate of 53 per cent of the marginal income in excess of $25,000 and less than $50,000, at which point the flat rate of 38 per cent applied to all the income.

Another result was to put a premium on smaller concerns keeping their net income below $25,000, since the 53 per cent prevailing in the next $25,000 was discouraging to the concerns that were likely to fall in that bracket. Furthermore, any peacetime rate of more than 50 per cent may also have an adverse psychological effect upon business, in that it signals a level of governmental expenditures and a fiscal policy to which the businessman is generally opposed. High rates also seriously limit the firm's ability to finance through the retention of income.

In 1949, the notch provision was removed and a "normal tax" plus a "surtax" with an exemption of $25,000 was substituted. This meant that all corporate net income would be taxed at the normal tax rate, and all income *over* $25,000 would pay an additional surtax. In 1949, these rates

were 23 per cent and 19 per cent respectively. This change thus gave a special tax privilege to corporations with a limited amount of net income ($25,000) and, in effect, called such companies small. Whether $25,000 is the correct point for distinguishing between small and large corporations is debatable, but the psychological objections to the "notch" method were avoided.

Taxation in accordance with ability to pay has become a well-established principle in connection with income taxes. However, the principle is generally held to be applicable only in relation to natural persons. If progressive rates were applied to corporations in any important way, the result would be most unequal, in that income belonging to stockholders in large corporations would be taxed at higher rates than income from investments in small corporations. Actually, the policy of progressive taxation of corporations has never been followed. The various measures favoring small corporations have always been thought of as providing "relief" for small companies rather than establishing the principle of progression or attempting to limit size through taxation.

The idea of progressive taxation of corporations is by no means dead and in recent years bills have been introduced to levy progressive corporate taxes. Most of the bills have proposed reductions in the rates imposed on small concerns with offsetting increases on large companies. The most steeply progressive proposal would reduce the normal tax to 22 per cent and levy a surtax as follows:[4]

Taxable Income	*Surtax Rate (per cent)*
Under $100,000	0
$100,000 to $500,000	10
$500,000 to $1,000,000	17
$1,000,000 to $5,000,000	22
$5,000,000 to $10,000,000	29
$10,000,000 to $50,000,000	32
$50,000,000 to $100,000,000	39
$100,000,000 to $500,000,000	42
$500,000,000 to $1 billion	49
$1 billion and over	53

This proposal would produce varying degrees of tax reductions to all corporations with income under about $50,000,000. There are only about 500 corporations above this size and probably only 1 in the largest size bracket. Consequently, this bill would cost the Federal Treasury in the neighborhood of $2 billion in revenues per year under present business conditions.

The regulation of corporate size through the use of tax laws would probably prove to be a complicated problem. Many companies would break down their operations into smaller units in order to put their in-

[4] H.R. 9067, introduced February 6, 1956 by Congressman Wright Patman of Texas.

come into lower brackets, or some other means of avoidance would be developed. But most serious of all would be the problem of what size was undesirable.

There is no necessary evil in size unless other factors preclude the entry of new risk capital into competition with established giants. Many lines of industry require large aggregations of capital for efficient operations. In others, large size may be entirely a matter of natural growth and internal policy. Some companies may have exceeded the size of maximum efficiency in terms of unit costs or returns per dollar of investment. The last-named condition may not be desirable, but it is hardly a matter for public concern so long as the company operates without practicing "unreasonable restraint of trade." With our present knowledge of economics, it seems likely that problems associated with size are principally problems of a monopolistic character and should be handled by more direct means than taxation.

ENCOURAGING THE USE OF EQUITY CAPITAL

As pointed out earlier, the federal income tax is a tax upon net income remaining after deducting typical business expenses, including interest on borrowed capital. It is constitutionally possible to devise a tax system which would differentiate between various forms or levels of income, but the present law attempts to reach only net income available for the ownership interests represented by the various forms of stock and frequently referred to as "equity capital." Interest paid upon the borrowed or creditor capital is deductible as a business expense before the tax is computed. The effect is to encourage corporate financing through the use of borrowed funds, represented mainly by bonds. There are many angles to the problem; but, from the point of view of public policy and sound business operation, important advantages arise in a greater use of venture or equity capital. Economic stability is increased, and the danger of forced liquidation and of receivership operation is reduced or avoided in hard times. The benefits to the stockholders arising from trading on the equity are limited, but so are the risks.

Prior to 1918, the income tax law restricted the amount of interest which could be deducted. In the first income tax law of 1913, interest could not be deducted on an amount of indebtedness greater than one half the total indebtedness plus the capital stock. The Revenue Act of 1916 relaxed this limitation with the provision that interest could be deducted whenever the indebtedness on which the interest was paid did not exceed "the sum of (*a*) the entire amount of the paid-up capital stock and (*b*) one-half of its interest bearing indebtedness then outstanding." Beginning with the 1918 law, all interest has been fully deductible except on debt that was incurred for the purpose of carrying tax-exempt securities.

Large amounts of equity capital would result in greater business stability in good times and bad. In terms of fiscal yield, a tax based upon operating income, i.e., income before the payment of interest and dividends, would also have advantages. It would broaden the base and reduce greatly the fluctuations in yield of the income tax from year to year. On the other hand, it would ignore certain legal realities which are inherent in any debt structure. Interest is a fixed charge which usually carries no option as to payment. If a company should find itself with reduced operating income, any tax on this income would increase its problems in meeting interest requirements. Such a situation might increase the number of failures, but it would also operate to discourage the use of borrowed funds in all but the cases of most stable income. Although the taxation of operating income would result in a reduction in the use of debt as a means of financing, the approach would be a negative one. It would also run headlong into an established body of business thought and practice. To the businessman, interest paid is a cost, not an economic share; and, as a cost, it should not be taxed. Far more practicable would be the positive encouragement to the use of equity capital which would result from a solution to the problem of double taxation.

Small Business Investment Companies. An interesting experiment in the use of tax incentives was inaugurated with the enactment of the Small Business Investment Company Act of 1958.[5] The new investment institution was designed to provide equity capital to the relatively small companies which have customarily found it difficult to raise long-term capital. As an inducement to the formation of the small business investment companies certain tax concessions were provided in accompanying legislation. Section 57 of the Technical Amendments Act of 1958[6] provided that any loss experienced by investors in the investment companies should be treated as an ordinary business loss and fully deductible instead of being treated as a capital loss and thus subject to the limitations applying to long-term losses. The act also provided that losses experienced by the investment companies as the result of purchasing the convertible debentures of the small businesses being financed would be treated as ordinary business losses. In addition, dividends received by the investment companies would be deductible in full instead of subject to the 85 per cent dividends-received credit applicable to corporations generally. The foregoing tax provisions have real merit in reducing risk and increasing net profits realized. It will take several years to determine the effectiveness and profitability of the new investment companies, but by August, 1961, 360 companies with a capitalization of $285 million had been formed.

Double Taxation of Corporation Income. One of the most serious inequities in the present tax structure, and one that has an important

[5] P.L. 699, 85th Congress.

[6] P.L. 866, 85th Congress.

bearing on the provision of equity capital, is the situation relating to the double taxation of corporation net income. The net income is taxed once in the hands of the corporation at a 52 per cent rate and again as dividends in the hands of the stockholder at rates ranging from 20 per cent to 91 per cent, subject to an over-all limitation of 87 per cent of total income. If a company paid out all its net after taxes, the net before taxes would have borne a tax burden ranging from 52 per cent in the hands of the usually tax-exempt stockholder up to 96 per cent[7] in the hands of a top-bracket stockholder. Although the typical stockholder would fall between these extremes, a total tax burden of 75 per cent of corporate income before taxes would not be unusual. Such rates are prohibitive under normal peacetime circumstances.

Two lines of attack exist to solve the problem. One would be to reduce the level of personal taxation, especially on the income levels from which equity investment is made. (Incidentally, it is on these incomes that the greatest burden of wartime tax increases was placed.) The other attack would be to eliminate or reduce the amount of double taxation. Considerations of fiscal and political expediency make the elimination of the corporate income tax unlikely but do not preclude the possibility of integrating the two taxes, with the tax on corporations being made a business tax at a moderate rate. The business tax would be deductible by the stockholder from his tax liability or dividend income. Whatever the method, any reduction in the double taxation of corporate income should furnish a positive encouragement to equity investment.

The Revenue Act of 1954 provided a small beginning on the solution of the double tax problem. The approach used was to provide a small reduction in the tax of the dividend recipient. The new law excluded from gross income the first $50 of dividends received by each taxpayer. In addition he was granted a credit against his tax, as otherwise computed, equal to 4 per cent of additional dividends received. This action did not represent a very large reduction in the double tax problem, but it did serve to establish the principle of such relief. While this may not be the best way to solve the double tax problem, there can be little doubt that a more substantial dividends-received credit would materially assist equity financing.

DIRECTED EXPANSION

Governments in this country have frequently supported certain phases of business activity. This has usually taken the form of a subsidy—direct in cases such as the land-grant railroads or the early canal companies, or

[7] Assume $1.00 of corporate net before federal income taxes. Deduct $0.52 corporate income tax and take 91 per cent of the remaining $0.48. This gives $0.44 individual income tax at the top-bracket rate. Adding this to the $0.52 corporate tax gives $0.96 total tax on that dollar of corporate income.

indirect as evidenced by protective tariffs. Again, the federal government has assumed the risks on capital investment in various categories of housing. To be sure, a fee is charged for this protection; but its adequacy is dependent upon conditions of economic stability or continuing inflation. Another way of achieving private action along lines deemed necessary in the public interest is through special tax privileges. The most recent and most prominent is the accelerated amortization of facilities deemed essential for the national defense.

During World War II, the government obtained a rapid expansion of facilities for defense production through three different avenues. One was through direct government financing and ownership of facilities under the management of the Defense Plants Corporation. Such facilities were usually managed by large corporations under fixed-fee contracts. The second method involved the use of private funds, which were repaid over a five-year period, with the title transferred to the government at the end of that time. The third method was through the tax privilege afforded by accelerated amortization.

Under normal tax procedures, depreciation may be charged against income only at rates closely related to the useful life of the equipment or facility in question. Typically, the useful life of machinery would be from 10 to 20 years and of buildings from 30 to 40 years. The Second Revenue Act of 1940 provided for the writing-off of any facility acquired for the national defense during the emergency period. The necessity had to be certified by the Department of War or Navy (later the War Production Board). During the World War II period, approximately 41,000 "certificates of necessity" were issued for such facilities, totaling about $7,300,000,000, or an average of $178,000 per certificate. In contrast, the government made direct investments of about $17,000,000,000 during the 1940–45 emergency period.

The Revenue Act of 1950 reintroduced the five-year amortization concept, while the guiding policy of the national defense program deemphasized direct government financing and acquisition of facilities for defense production. The President was authorized to issue certificates of necessity for facilities acquired or completed after December 31, 1949, where such facilities were necessary for the national defense. In practice, the word "necessary" has been interpreted rather broadly to cover related needs for such items as basic raw materials or transportation facilities. Unlike the 1940–45 period, the certificates have generally been issued for some percentage less than 100 per cent of the value of the facility. This is to allow for estimated postemergency usefulness, on the one hand, while being high enough to provide adequate incentive, on the other. From October 30, 1950 to March 21, 1956, the government received 31,367 applications covering actual or proposed expansions. Certificates were issued on 20,770 projects for a total of $34,836,769,000 or an average of about $1,678,000. The average amortization percentage authorized was

60 per cent. This means that 60 per cent of the typical project could be charged off in five years while the balance could be charged off only at the rates usually applicable.

Such a bold use of taxation in the direction of the nation's industrial expansion has many serious tax implications. Among the more important are the aggravation of inequities and illogicalities in the distribution of the tax burden upon corporations generally and among corporations individually, as well as the stimulation of certain segments of the industrial economy while the remainder is held as nearly static as possible. Finally, as previously noted, it suggests that any compensatory efforts in the post-emergency period must take the form of increased regulatory action by the government or, even less desirable from the tax viewpoint, further use of the tax structure to achieve indirectly—and, consequently, with less effectiveness—some facsimile of the declared objectives. It is evident that the critical determinations to be made with respect to the post-emergency values and the degree of financial incentive required to direct expansion in the desired areas during the emergency period are so much a matter of conjecture as inevitably to compound the undesirable tax consequences of this device.

The Revenue Act of 1954 included a powerful stimulus for expansion generally in contrast to directed expansion. This was the provision for "accelerated" depreciation. While the Internal Revenue Code had authorized the deduction of a "reasonable" allowance for depreciation in computing taxable income, this had been widely interpreted to mean depreciation as determined by the straight-line method. Moreover, the allowable lengths of life used in determining the rate were often based on engineering usefulness with little or no allowance for economic obsolescence. Under the 1954 Act, the taxpayer may compute his depreciation allowance (*a*) as he has done in the past, (*b*) under the declining balance method at twice the straight-line rate, or (*c*) under the sum-of-the-years digits method. Method (*b*) will recover two thirds of the investment in half the life of the asset. Method (*c*) would permit a somewhat more rapid recovery in the early years of the asset's life. There can be little doubt that these methods were factors in the capital goods boom of 1955–56.

BUSINESS EFFECTS OF TAXATION

The normal objective of management is to run a business with the lowest possible costs consistent with the corporation's established operating policies. This search for profits is often affected by the complex structure of federal, state, and local tax systems, which may present corporate managements with opportunities to make choices permitting lower taxes. It is to be expected that management will always endeavor to minimize taxes like any other cost, unless there are offsetting reasons for

not doing so. Thus, many corporations paid the undistributed profits tax in 1936 and 1937 because they felt that the earnings were needed in the business. Likewise, corporations of substantial size do not ordinarily divide their operations to obtain the lower rates available to the smaller corporations. There would be offsetting disadvantages far outweighing any tax savings. However, this is only to say that taxation does have an effect on business policy. Some of these effects may now be examined briefly.

LOCATION AND FORM OF ORGANIZATION

As mentioned in Chapter 4, the selection of a state for obtaining a charter may be influenced by taxation. Organization tax rates vary from one hundredth of 1 per cent to one third of 1 per cent of authorized capital stock. In addition to organization and franchise taxes, states vary in the burden placed upon incorporated business through special taxes upon property, income, or the nature of business done. Ordinarily, there are other economic factors more important than taxes in selecting the state for incorporation; but the relative tax burden among states is definitely a consideration.

Special corporation taxes may have a material influence both on the form of organization and upon the mode of conducting business. A relatively heavier tax burden upon incorporated as compared to unincorporated enterprise may easily be the marginal factor which determines whether a business should incorporate at all. Although the incorporation carries the advantages of limited liability and continuity of existence—to name two features which have been discussed elsewhere—these benefits are partly offset by special costs. As a consequence, many small enterprises which might like to incorporate for the sake of limited liability may find it more profitable to assume the unlimited risks attendant upon the proprietorship or partnership forms of organization.

The effect of taxation on forms of organization is shown by the tendency of small corporations to dissolve and return to an unincorporated form of organization during the years immediately preceding World War II. During the war itself, this trend became more marked, due to the extreme levels of corporate taxation under the excess profits tax. With the repeal of the excess profits tax in 1945, the tendency to "disincorporate" was checked; but the tax structure was still not as favorable to incorporated business as in earlier decades. With the re-enactment of the excess profits tax in 1950, we again saw a tendency for smaller corporations to "disincorporate." Large concerns, on the other hand, continued to find the corporate form necessary because of widespread ownership and financing considerations.

An excellent example of special taxes is found in many states in their tax treatment of chain stores. The taxes are usually progressive and are

based upon the number of unit stores operated in the individual chain. Most, if not all, chain-store organizations are incorporated. They are singled out for special tax treatment, partly as a productive source for tax revenue and partly because of a desire to impose punitive taxes upon a politically unpopular form of organization. As a result of such taxes, chain-store corporations have been forced to adopt business policies which hold the taxes to a minimum. One method is to lease the separate units to the managers, who thus become private enterprisers and are technically in the position of customers of the parent organization. This has been done by some of the large oil companies for their operations in chain-store-tax states. Grocery chains have tended to adopt the policy of greatly reducing the number of units operated and increasing their size. What are popularly referred to as "supermarkets" are opened, and all existing smaller units in the same neighborhood are closed. This has served to reduce greatly the base for chain-store taxes and has also proved to furnish a powerful promotional device for adapting such businesses to patterns of motorized living.

TAXATION AND METHODS OF FINANCING

Existing tax systems tend to place a premium on one form of financing as compared with another. Income tax laws allow the deduction of all interest paid before arriving at net income subject to taxation. This makes it more profitable, tax-wise, for corporations to use bonds or other forms of debt instead of stocks as a means of financing. Each dollar of operating income used to pay interest reduces income taxes by an amount equal to the tax rates per dollar. Every dollar not so used must be reduced by the tax rate *before* it can be used for dividends. There will usually be other factors which will influence the method of financing used, but corporations have been known to issue debenture bonds to retire preferred stocks carrying an equivalent dividend rate simply to reduce the tax load.

Of lesser importance, though similar in tendency, is the fact that state franchise taxes are usually based on authorized or outstanding capital stock. The franchise tax rate is not high in most states, but it does lend encouragement to hold authorizations or issuances of stock to a minimum and to use bonds as a source of funds.

TAXATION AND SOURCES OF FINANCING

The most important effect of taxation upon corporate financial policy is its influence on the sources of financing. Broadly speaking, a corporation has only two sources of funds for expansion purposes: (1) retained earnings and (2) the savings of individual and institutional investors which are obtained through the sale of securities. With extremely high levels of taxation, such as during World War II and under the present emergency defense program, these sources are restricted.

Prior to 1940, the federal corporate income tax rates had never exceeded 15 per cent. During the war years, the basic corporate rate reached 40 per cent; and, in addition, there was levied a tax of 95 per cent of excess profits. It must be admitted that corporate profits were large in those years and that substantial sums remained after taxes for corporate purposes; but it is also true that the volume of economic activity was tremendous and that capital requirements were huge.

Following the close of 1945, the federal income tax rate, except for the smallest corporations, remained at 38 per cent until the revenue and excess profits acts of 1950 increased the maximum rate for the combined taxes to 62 per cent. This was followed in 1951 by a maximum combined rate of 70 per cent. This portion taken from corporate earnings, when added to necessary dividend disbursements, meant that savings for expansion purposes would be severely limited. But any serious thought on the burden of corporate taxation must be in terms of probable future levels of activity, costs, profits, and incentives. It is quite likely that a lower corporate tax rate must be found possible if corporations are to maintain themselves on a healthy and progressive financial basis.

The expansion capital problem of corporations is influenced by personal income tax rates to an important degree. Although retained earnings have usually provided more new capital than has new outside investment, this does not mean that new investment is unimportant. Actually, billions of dollars in capital must be obtained from private investors; and much of it should be on an equity or venture basis. The increasing difficulty in raising new capital may be attributed in part to profit uncertainties and in part to the tax load on personal investors.

Table 43 (p. 462) gives the rates of the federal personal income tax established by the Revenue Act of 1954. When it is recognized that the bulk of saving for investment is done by persons with incomes of $10,000 and over, it is easy to appreciate how this source of capital funds has been restricted. The restrictions would be far more serious if it were not for the 25 per cent tax-rate ceiling applying to long-term capital gains. This rate is not prohibitive in any situation where it is possible to take out profits in the form of capital gain.

The most direct influence of the currently high personal tax rates is upon the willingness to assume risks as much as upon ability to save. It is one thing to assume investment risks in the hope of additional income when that added income will be taxed at a 20 per cent rate and quite another when the added income will bear taxes upward to 91 per cent. To many investors, it looks too much like keeping all the losses and paying out all the profits in taxes. When we consider that a top-bracket income recipient would need a return of nearly 36 per cent from a private investment to equal, after taxes, a 3½ per cent return on a tax-free state bond, we may well wonder why such individuals have any permanent investments in the equities of private corporations.

TAXATION AND ACCOUNTING POLICIES

One of the recent developments brought about by the current tax system has been a rather widespread re-evaluation of accounting methods and policies. The purpose of accounting is to keep account of the values flowing through a business in order to report as realistically as possible the values on hand at a given date and the income produced during a given period of time. Since accounting is not an exact science, it follows that the practices used at any time can be changed when necessary, with marked changes in reported values and reported income. The significance of these statements can be illustrated by a brief examination of inventory accounting policies.

Accountants have traditionally advocated that inventories be valued on the lower of cost-or-market values. When physical counts of goods on hand are made at the end of the accounting period, this method can be applied literally. Where perpetual inventories are maintained, this method resembles the "first-in—first-out" or "Fifo" method; that is, it is presumed that the first goods purchased are the first to be sold. Both versions have the advantage of being 'conservative," i.e., they recognize inventory losses but fail to recognize inventory profits. On the other hand, they exaggerate profits in periods of rising prices, and losses in periods of falling prices. Since the last twenty years have been a period of generally rising prices, accountants have been keenly aware of this profit exaggeration. With rising tax rates, any overstatement of income has had especially serious financial implications.

Prior to 1939, the Treasury Department had required corporations (and other business concerns) to use Fifo, the lower of cost or market, or some variation of these methods. Accountants in industries where inventories are large and subject to unusually wide market fluctuation had advocated some method which would exclude or reduce the effect of inventory gains or losses. In 1939, the Treasury authorized the use of Lifo, last-in—first-out, as a method of accounting for the inventories of manufacturing concerns. Since the last goods purchased will be the most costly in a period of rising prices, selling them "first" has the effect of reducing reported profits. In other words, Lifo reduces the reported income in periods of rising prices and increases it in periods of falling prices. Any reduction in reported income in periods of rising prices reduces taxes and increases the amount of liquid funds available for carrying the larger dollar-value inventory resulting in part from the rising prices. In periods of falling prices, this higher earning will result in higher taxes; but the declining inventory requirement will free funds for meeting the increased taxes.

Whether a company saves in taxes under Lifo will depend on future price trends, future tax rates, and the industry in which it operates. But it is likely that, where appropriate, the method will aid in the problems

of financial management. It also appears evident that tax considerations are the reason for its constantly widening adoption.[8]

THE LEVELS OF TAXATION

The level of taxation may be a significant problem both in terms of control of business activity and in terms of unavoidable business effects. To be effective as a limiting device, taxes must be placed at sufficiently high levels to discourage or prevent designated activities. The undistributed profits tax of 1936 is an illustration of a tax designed to discourage the retention of earnings; the federal tax on the note issue of state banks is a case where taxes have stopped an otherwise legally permissible activity. A different situation exists when taxes must be set at high levels because of revenue considerations.

Before the World War II period, corporate taxes amounted to about $1.00 in $7.00 of taxable income. During the war, the corporate income tax reached a $2.00 in $5.00 level plus an excess profits tax of substantial amount. Today (1961), the corporate income tax takes over half of a corporation's net income. On the personal tax side, $2.00 out of $5.00 income are taken at the $10,000 level of taxable income; $2.00 out of $3.00 at $25,000; and $9.00 out of $10.00 at $100,000. Tax rates such as these greatly limit the capacity of business to grow and of individuals to invest. Moreover, at some as yet unidentified level, taxes are likely to have an effect on incentive to produce. This level is undoubtedly much higher than some people have believed; but it exists, as is evidenced by the waste observed under the World War II and Korean War excess profits taxes. At a time when the prime goal of the economic planner is increased production, we find the distribution of the burden of taxation to be one of the serious limiting factors both in terms of ability to save for investment and in terms of the willingness of the investor to make risk investments. Perhaps the question should be asked if the level of taxation and the nature of the tax system may not be in the process of bringing about a change (albeit unintentional) in our economic system.

QUESTIONS AND PROBLEMS

1. Investigate the various proposals for eliminating (or reducing) the double taxation of corporate income. Evaluate each in contrast with the "dividends received credit" principle contained in the Revenue Act of 1954.
2. Compare the special taxes applicable to a chain store with thirty units in Illinois, Louisiana, and West Virginia.
3. What are the characteristics of a corporation which warrant special tax treatment?
4. Why must small concerns rely so heavily upon the retention of earnings

[8] For a complete analysis, see J. Keith Butters, *Effects of Taxation: Inventory Accounting and Policies* (Boston: Harvard University, 1949).

for expansion capital? Are the new small business investment companies likely to provide an appropriate solution?

5. Compare the cost of obtaining a charter with $5,000,000 in authorized stock in four states other than those given in Chapter 4.
6. "Taxes should be levied to produce the necessary governmental revenues with the least possible effect upon business activity." Discuss.
7. What do you regard as an "excessive" return upon capital invested in business enterprise? What factors did you consider in reaching your conclusion?
8. "Regulatory taxation ignores personal equity and considers only economic results." Can personal equity and economic results be separated?
9. Discuss pro and con the social desirability of equity financing in favor of creditor financing.
10. "Progressive taxation is equitable only in relation to individuals. Corporations should be taxed only at proportional rates." Discuss this viewpoint.
11. How high may excess profits taxes go in peacetime without checking business initiative?
12. "Rather than pay these outrageous taxes, I will raise wages and pay bonuses so that there will be no excess profits in my business." Discuss this viewpoint.
13. Secure a copy of S.2, 87th Congress 1st Session, and analyze its proposal for a "reinvestment tax credit."
14. Evaluate taxation as a factor in the declining share of national income constituting corporate earnings? Are there other important influences?

REFERENCES

BLOUGH, RAY. "Taxation and Anti-inflation Policy," *Social Science*, Vol. XXVI (June, 1951), p. 153.

BUEHLER, A. G. *The Undistributed Profits Tax*. New York: McGraw-Hill Book Co., Inc., 1937.

BUTTERS, J. KEITH. *Effects of Taxation: Inventory Accounting and Policies*. Boston: Harvard Graduate School of Business Administration, 1949.

——— and LINTNER, JOHN. *Effect of Federal Taxes on Growing Enterprises*. Boston: Harvard Graduate School of Business Administration, 1945.

COMMITTEE ON POSTWAR TAX POLICY. *A Tax Program for a Solvent America*. 2d Report, 1947. New York: The Ronald Press Co., 1947.

CRUM, W. L. "The Taxation of Stockholders," *Quarterly Journal of Economics*, Vol. LXIV (February, 1950), p. 15.

How Should Corporations Be Taxed? A symposium. New York: Tax Institute, Inc., 1947.

KIMMEL, LEWIS H. *Taxes and Economic Incentives*. Washington, D.C.: Brookings Institution, 1950.

OLDS, FRANK V. "Decade for Depreciation Decisions," *Harvard Business Review*, Vol. XXXVIII, No. 6 (Nov.–Dec., 1960), p. 27 ff.

SCHLAIFER, R., ET AL. "Accelerated Amortization," *Harvard Business Review*, Vol. XXIX, No. 3 (May, 1951), p. 113.

SENATE SMALL BUSINESS COMMITTEE. *The Effects of Depreciation Policies on Small Business*, Washington, D.C.: U.S. Government Printing Office, 1960.

SHOUP, CARL. "The Taxation of Excess Profits," *Political Science Quarterly*, Vol. LV (1940), pp. 535–55; and Vol. LVI (1941), pp. 84–106 and 226–48.

———. *Taxation, Recovery and Defense*. Monograph No. 20. Washington, Vol. XXIV (May, 1951), p. 327.

SMITH, DAN THROOP. *Effects of Taxation: Corporate Financial Policy*, Boston: Harvard Graduate School of Business Administration, 1952.

"Special Report: Small Business Investment Companies," *Forbes*, Vol. 88, No. 6 (September 15, 1961), pp. 27–30.

STUDENSKI, PAUL, and GLASSER, GERALD J. "New Threat in State Business Taxation," *Harvard Business Review*, Vol. XXXVI, No. 6 (Nov.–Dec., 1958), pp. 77–92.

TEMPORARY NATIONAL ECONOMIC COMMITTEE. *Taxation of Corporate Enterprise*. Monograph No. 9. Washington, D.C.: U.S. Government Printing Office, 1941.

———. "Taxation for Defense," *Proceedings of Academy of Political Science*, D.C.: U.S. Government Printing Office, 1941.

U.S. SENATE, COMMITTEE ON FINANCE, 83RD CONG., 2ND SESS. *Internal Revenue Code of 1954*. Senate Report No. 1622. Washington, D.C.: U.S. Government Printing Office, 1954.

U.S. HOUSE OF REPRESENTATIVES, COMMITTEE ON WAYS AND MEANS, 83RD CONG., 2ND SESS. *Internal Revenue Code of 1954*. House Report No. 1337. Washington, D.C.: U.S. Government Printing Office, 1954.

Chapter 35 ►

CORPORATION FINANCE AND PUBLIC POLICY

WHEN WE consider corporation finance in its relation to public policy, it is highly important to recognize that the underlying problem is much more than a question of philosophy or of abstract analysis. All too frequently, there is a tendency to think of finance as a strictly technical and operating activity and to regard the public responsibilities of a corporation as a form of extracurricular or side-line interest. However, if we envisage the larger setting, it is clear that corporations can no more pursue a policy of isolation in business matters than can the nation in foreign affairs. Inexorably, the character and nature of business conduct are largely molded by public attitudes and by the type and form of government. For example, even before the Communist assumption of power in Czechoslovakia, all industries employing more than 500 workers were taken over by the state.[1] This foreign land may seem far away and the situation there not at all comparable with our own, but the fast-moving events of recent years give no such assurance. The times are such that we know that pronounced changes in business systems can be brought about by elections as well as by wars.

PUBLIC POLICY IN THE ASCENDANCY

It has been said that public policy is "a very unruly horse, and when once you get astride it you never know where it will carry you."[2] However, despite the dangers that are inherent in overemphasis of public policy, it has become an increasing force in the motivation and direction of society. It is not easy to detect or to evaluate long-term movements, but it is likely that the trend in this direction has been under way for a considerable period of time. Its manifestation in some parts of the world has taken the form of complete domination by the state; in our own country, its development up to this point has been in the background as

[1] B. Nover, "Czechoslovakia Gets Her Orders," *Washington Post*, July 12, 1947, p. 5.

[2] As quoted by Roscoe Pound, "A Survey of Social Interests," *Harvard Law Review*, Vol. LVII, No. 1 (October, 1943), p. 5.

a supplementary support which is intended to undergird private activities.

As evidence of the increasing force of public policy in the United States, we need simply to note a few of the major changes in our economic system since the turn of the century. Seeking constantly to guard against the hazards of depression, we have sought to buttress private enterprise with various forms of public assistance. In 1913, the Federal Reserve System was introduced as a means of relieving tight money and credit conditions, after which special forms of financial accommodation were made available to agriculture. In the thirties, private business itself turned to government for aid on an unprecedented scale.

One writer has observed that the "great depression beginning in 1929 must be set down as one of the most profoundly explosive events in all world history."[3] We are still too close to the event to appraise its larger realities; but, without question, it did give emphasis to regulatory controls. Regulation is commonly regarded as an attribute of government, but we may note that it also has a larger meaning. Some form of control or directional force is necessary in any type of society. Under communism, it is the government; under capitalism, it is the functioning of the market place. Unfortunately, under the stress of profound, moving social events, the market is no longer free; and, as a result, public policy has assumed a larger role in the conduct of our economic life. There may be nostalgic yearning to return to the "good old days"; but compelling realism, more than emotional impulse, will provide the answer. Viewed in this light, private enterprise must be coldly practical about existing uncertain conditions in its formulation of financial policies.

Corporate welfare rests upon a foundation of social or public recognition, and it is vitally affected by widespread unrest and disturbance. The actions of corporations in dealing with public problems are not the extra efforts of altruistic endeavor because they may have significant and practical bearing upon the long-term business outlook. Reflecting this broader approach toward the public interest is the statement made by the board of directors of the Standard Oil Company of New Jersey in its *Annual Report for 1945*:[4] "The Jersey company has obligations as a citizen, among them: to act always with a consciousness of the public interest; to recognize that a good example is a great constructive force; to work for the common good, supported by a conviction that what is in the interests of the people is in the best interests of Jersey."

BUSINESS POLICY, MANAGEMENT, AND RESPONSIBILITY

To determine the type and character of business and financial policy which may be justified, we should recognize that it must necessarily

[3] Alvin H. Hansen, "Stability and Expansion," chap. v of *Financing American Prosperity—A Symposium of Economists* (New York: Twentieth Century Fund, Inc., 1945), p. 200.

[4] Standard Oil Company of New Jersey, *Annual Report for 1945*, p. 3.

change in order to keep in tune with new conditions. Illusive and intangible though it may be, policy may become obsolete just as much as physical products. Actually, the policies that motivated business operation prior to the thirties may be just as outmoded as the automobiles of that earlier period. Even a quick look at the change in labor conditions and in relations with government suggests some of the differences in atmosphere and in the business problems to be faced.

One authority has well observed that the caliber or type of businessmen must evolve in keeping with the new demands of society.[5] It was pointed out that, prior to the Civil War, business was represented mainly by "the owners of small individual businesses, largely local in character." In the latter part of the nineteenth century, the so-called "captains of industry" made their appearance and were shortly followed by "corporate speculators and plungers." Undoubtedly, the latter are still a part of the current picture; but the same authority points to the emergence of a new type known as "career men" in business. These are

> men who can never hope to own any large portion of the enterprise of which they are a part; men who realize that the bonanza days of the old captains of industry are over; men who see in business something more than the mere making of money; men who are imbued with a deep sense of social stewardship; men who are keenly sensible of the fact that they are the trustees of other people's money with heavy responsibilities to discharge to employees and the public as well as to stockholders; men who find deep spiritual satisfaction in the direction of their brains and energy toward the creation of a better and more abundant life for all of their fellow human beings.[6]

The sense of a "career status" in private business is undoubtedly present in many cases, but it is important to recognize that it must ever be nurtured. The common desire to "make money" for its own sake is almost a natural urge in a free economy, but, as indicated in the introductory chapter, we must be aware of the qualitative as well as the quantitative aspects of "money-making." Particularly is it easy to lose perspective in a period of prolonged prosperity, especially if taxes make heavy inroads upon both personal and corporate income. Individual managers may be induced to accept positions by lucrative stock options, while large corporations may yield to the temptation of fixing prices by use of monopolistic practices.

Yet if we are to preserve our way of life, we must have constant awareness of the meaning and significance of responsibility.[7] Throughout this volume, we have tried to keep this thought in the background of

---

[5] See H. W. Prentis, Jr., President, Armstrong Cork Company, Lancaster, Pennsylvania, an address delivered before the Conference on General Education, sponsored by the colleges and universities of Pennsylvania at Franklin and Marshall College, Lancaster, Pennsylvania (June 26, 1947), as reported by *Vital Speeches of the Day*, Vol. XIII, No. 20 (August 1, 1947), pp. 619–23.

[6] *Ibid.*, p. 620.

[7] Also see p. 736.

our observations, believing that economic responsibility is both exercised and manifested by finance. One well-known person, who has held high office in both private and public affairs, declared:

> In the last analysis, the ability of the American economy to sustain orderly growth, to generate increased useful employment, to provide sufficient real capital to finance expansion, and to function as a source of strength for the entire free world, all depends on the maintenance of financial responsibility.[8]

THE NATURE OF SOCIAL RESPONSIBILITY

Unlike individual responsibility, which is easily brought into focus and is universally recognized, it is not so simple to resolve the larger accountability which attaches to society. At the same time, it must be clear that no society can long exist without positive objectives and without definite assumption of the responsibility for its well-being. It is tradition under capitalism that the function of stewardship is automatically discharged by the activities of a free market. But in recent times, significant world and national events have upset the balance of a free market; and there is need to evaluate the results in the light of these conditions.

In retrospect, the word "responsibility" frequently connotes blame. This would not be true if the purpose were to ascertain those who were to be accredited with successful operation. But success is usually taken for granted, and inquiry is more commonly instigated in the event of failure; hence the more unsavory connotation of responsibility as a source of error or mistaken judgment. There will be little occasion to use the term "responsibility" in this sense here, because our objective is to look to the future. Our inquiry concerns the course of action which will assure maximum production, as well as its distribution to accommodate a standard of living which is justified in the light of our resources. From this point of view, responsibility may be interpreted by posing the question: Who will be charged with the task of producing sound prosperity and the development of maximum social welfare?

If it were simply a matter of finding jobs for all, extremists might well advocate the creation of some form of dictatorial government. On this basis, employment would be ordered in the mass instead of individually sought. Already, it is known from the experience of other nations how quickly unemployment may be ended by arbitrary state control. However, the cost of this totalitarian process cannot be easily estimated. Aside from the effect upon personal liberties, there is no guaranty that forced employment will assure higher wages or an improved standard of living; on the contrary, there is the possibility that living standards will be lowered.

---

[8] Julian B. Baird, former Under Secretary of the Treasury, "Of All the Tasks Today, What's Tougher Than WHAT THE TREASURY FACES," *The Mortgage Banker*, October, 1960, p. 5.

The problem that confronts us is especially perplexing in a democracy, where maximum emphasis is placed upon individual initiative and enterprise. Under such a system, it is felt that the promotion of individual efforts on a wide front must of necessity produce the greatest social good. Unrestricted individual activity seems to afford the advantage of the vigor and diversified strength of spontaneous response in contrast to the less stimulating character of directed action. The limited character of our discussion precludes a full analysis of the many developments which have served to curb the free working of a competitive system, but it should be noted that various limiting factors in the form of monopolistic practices and other elements of rigidity have become parasitic attachments to the body economic over a long period of years. Even more far-reaching in their influence were the depression of the thirties and World War II.

PARTICIPATION BY GOVERNMENT

Under the burden and extreme despair occasioned by depression, free enterprise voluntarily turned to government for various forms of assistance. Then, in the fight for our national existence during World War II, the authority of the state became a recognized necessity. Now, we are faced with the challenging task of determining the part that government will play in our economic life; and it is a little disturbing to our traditions to ponder the prospect that it may be a permanent, component part of our business system. It may be that, in many quarters, government is no longer regarded as the invited guest but is viewed as the relative who has overstayed his welcome. But nostalgic sentiment must not be permitted to blind us to the realities.

For better or worse, government is wedded to business enterprise by ties that are bound to exist irrespective of the political party which may be in power. A debt has been created that will require taxes for its servicing for decades to come. Business will be called upon to shoulder a heavy share. Direct loans have been made which automatically give the government a voice in operating policies. Indeed, in certain instances, terms of agreement relating to the loans give express authority to the government's lending agency to change management personnel. Viewed in a philosophical vein, such controlling relationships may come as a rude shock to those who worship at the shrine of a century of virtually free and unbridled enterprise. But the answer cannot come so simply from fond recollection; instead, it can emerge only from a frank realization and consideration of the facts as they exist.

THE EFFECTS ON BUSINESS POLICY

Because government participation is no longer a matter of free alternative, at least to the extent of its present encroachment, it follows that

the formulation of future business policy must provide for adequate representation of the public interest. It is easy to deride this observation as encouragement of socialism, but such ready dismissal overlooks the incidences of control arising from dollars and cents investment previously cited. No attempt is being made here to advance individual preference as to the form of our economy; rather, it is the hope to prognosticate in the light of facts that already exist.

The common interests of both government and business will undoubtedly compel some form of co-operative effort.[9] This will necessarily produce various changes from the old business process as well as modify incentives that have stimulated business activity in the past. For instance, there is already evidence that individuals of both low and high standing are attaching more significance to the wages or salary received from a job than to the profits that characterized business opportunities of the past. Fears may be expressed about this lessening of the profit motive, but disaster is not necessarily the inevitable outcome. Instead, other forms of organization are likely to evolve with reasonable opportunity for individual participation and initiative. As a possibility, it may be that greater use will be made of mutual organization, a basis upon which life insurance companies have already made an enviable record.

Another compelling force which is likely to give emphasis to greater participation by government is the uncertainty and instability of our times. One need not be a gloomy prophet to entertain the existence of this contingency; rather, there is no escape from the realities of the provoking and far-reaching social problems which have followed in the wake of World War II and which continue as an incident of the ensuing cold war. Paradoxical as it may seem, war appears to act as a business stimulant, whereas the ensuing peace seems to provoke instability and restlessness. This is not surprising when one recognizes the disturbance that is created by numerous shifts and adjustments within the economy caused by the transition. Moreover, experience has now shown that business itself will likely turn to government for assistance.

What the precise pattern of organization will be is not now apparent. It will probably unfold as the problems present themselves and solutions are attempted. That there will be room for both government and relatively free private institutions seems to be a reasonable assurance in our own country at the moment. Much will depend upon the extent to which business corporations recognize and provide for broad social responsibili-

[9] Charles E. Wilson, then president, General Electric Company, commented in "Total Security—A Challenge," an address before the Midwinter Convention of the American Institute of Electrical Engineers, Philadelphia, Pennsylvania, January 29, 1941, p. 10, as follows: ". . . I present no thought of arm's-length co-operation, overshadowed by suspicion between government and business. Instead, I seek arm-in-arm concord and co-ordinated effort in the common good—the kind of concord and effort which can, in my judgment, eliminate the causes of conflict, competition, and confusion between government and business."

ties which have previously been regarded as extraneous to their operation. In short, it appears that there will be joint responsibility; and our discussion may now turn to an analysis of the respective parts to be played by the two parties.

CORPORATE RESPONSIBILITY

Corporations have generally pursued a policy of isolationism. They were deemed to be distinct entities seeking to advance their own restricted interests; simultaneously, it was believed that this self-advancement automatically contributed to the welfare of the entire society. Largely as a result of thriving business over a long period of years, this developed into a sort of tradition. But events of recent times have tended to break through this shell of corporate identity and to cause several questions to be raised about the responsibility of business toward the whole economy. Especially is this true as it relates to the large corporation. "The large corporation is not a vastly enlarged small corporate enterprise. It is qualitatively different. It has become a unique institution."[10]

On a number of occasions, it has been indicated that the corporation owes its birthright to the state; and, for this reason, it may be held to have a definite obligation to the public as well as to the more specific owners of the enterprise. However, as with so many bestowed rights, it is easy to take them for granted once they become a common privilege. Similarly, incorporation has come to be regarded as being available for the asking rather than being granted upon proof of service to be rendered. To remove this bias of established practice, it is desirable to recall the character of the corporation's origin.

In earlier years, incorporation was effected by legislative enactment; and each individual application was given special consideration as a matter of public policy. It is true that political abuses and increased demand for the corporate form led to the passage of general incorporation statutes, but it is important not to overlook the original classification of the corporation as an instrument of limited availability. In principle, the grant of charter was to facilitate the "fulfillment of some public purpose. Nor was the advancement of private interests deemed a sufficient justification for the grant of such privileges as perpetual succession, limited liability, and delegation of power to designated individuals to act for the group."[11]

Reference to this early aversion toward the granting of broad powers to private corporations may appear inopportune because of its remoteness

---

[10] A. A. Berle, Jr., "Corporations and the Modern State," in *The Future of Democratic Capitalism* (Philadelphia: University of Pennsylvania Press, 1950), p. 38.

[11] Lyon, Watkins, and Abramson, *Government and Economic Life* (Institute of Economics of the Brookings Institution, Vol. I, No. 79) (Washington, D.C.: Brookings Institution), p. 49.

in time. To a great degree, rights are evolutionary in character and are necessarily attuned to the conditions that prevail at any given moment. In this light, the march of business over the past century is bound to be a conditioning factor of first rank. It may well be cause for changing public policies in granting charters. However, this type of reasoning must apply equally to the new set of conditions which has developed over the past two or three decades. In short, for the same reason that expanding business of prior periods may have justified more liberal treatment of corporations, the retrogression of the thirties and the war booms of the forties may be held to be sufficient cause for curtailment now.

Another feature of the present corporate structure which lends emphasis to the public interest is the separation of ownership from control. Legally, the stockholders have the power to elect directors; but the difficulties of exercising this privilege intelligently are well known. In any event, there is created a condition in which the interests of the many are placed in the hands of the few. Although it may be recognized that this delegation of authority is a most necessary requisite of orderly management, at the same time the character of the responsibility that is created is equally one of a broad, trustee nature. In fact, the representation takes on a form of public interest.

If, then, the responsibility of the corporation toward the social economy be recognized, what is its precise character? Rather than offer any final pronouncement in answer, it is fitting to give consideration to the opinions that have general circulation. Here, increasing attention is being paid to the accountability of the corporation for matters within its household as well as to the various obligations outside the field of its immediate operations. Broadly speaking, therefore, the responsibilities of a corporation may be classified according to (1) those of an internal nature and (2) those of an external nature.

Internal Responsibility. To a great extent, recognition of corporate internal responsibility may be taken for granted. The only possible dispute concerns its character—narrow or broad, spontaneous or coerced, restricted or comprehensive. In short, is the broad purpose of corporate policy one of advancing and accounting for investor and public interests; or is it primarily designed to favor special interests? Many instances are on record where the few on the inside capitalized on their favored position at the expense of the larger group which furnished the capital and carried the real risk. As a result, there is today a profound public consciousness of the need for proper corporate accounting.

There follows the question as to the situs of the responsibility for the provision of proper accounting and adequate protection of all the various interests. It may be contended that investors already have the necessary legal rights to defend their interests, as well as having access to the courts. However, the expense of litigation and the practical obstacles which prevent joint action preclude prompt and effective response on

their part. Under the circumstances, there is need to correct the impotency of scattered investors if their existing rights are to be exercised. Thus, there has developed a marked tendency to designate government as a sort of indenture trustee to act in behalf of those having investment in business enterprise.

The enlargement of the supervisory powers of government is usually the cause for surprise and shock in the business community. But careful examination shows that often no new rights are created; instead, there is simply an empowering of governmental agencies to enforce rights already in existence. The immobilized state of investors had largely prevented giving effect to the numerous powers, whereas the mobilized force of government is more likely to induce their application. Of course, it is important that the objective of supervision by government be kept in mind. When it is used for punitive or arbitrary purposes, there exists a form of abuse just as if special, private interests had vitiated their trust.

When private management holds its trust in high regard, there should be little occasion for governmental interference. Often, however, there is a tendency for management to develop a form of vested interest. Particularized motives may supplant the larger, corporate interest. Peculiar rights are believed to accrue in favor of management or controlling groups by virtue of their record or long association with an enterprise. Like lords of ancient feudal estates, inside interests assume prerogatives with reference to their industrial domain. As a consequence, there is failure to recognize the true legal relationship which exists between management and owner. Overlooked is the basic premise that "other people's money" is being used to conduct business enterprise.

In large-scale business today, management is a delegated function. The delegation is underwritten by powers of attorney or other legal means; but, at the same time, the very franchise of authority carries definite and implied obligations of responsibility. Especially does this mean complete accounting by management for its activities. The real issue is, therefore, who will determine the adequacy of the accounting. Ardent advocates of individualism naturally declare this to be solely within the province of the private owners. Others believe that government has a moral obligation to assure full and complete accounting. Emphasis is placed upon the fact that the charter is a form of special privilege granted by the state and that its continuance depends upon the way in which the privilege is exercised.

Much of the conflict between the two philosophies could be eliminated if their representatives would place less stress on the means and always keep in focus the common objective. Either course utilizes the agency principle, the choice being whether widely scattered investors shall be represented by private parties or by agencies of government. American tradition undoubtedly favors the former, and recourse to authoritarian procedure should be a last resort. It is only when serious abuse develops

under private representation that government should proceed to take action. The danger today is that the introduction of governmental authority to correct admitted abuses may cause the agencies of government to go beyond the point of correction. History records in no uncertain terms that the momentum of unleashed governmental action often carries beyond the role of umpire into that of active participant. For this reason, there is real need to think through various reforms, with full recognition of the ultimate as well as the immediate effects.

The expansion of the regulatory power of government does seem inconsistent with the emphasis placed upon private rights throughout the development of our country. It was assumed that the cultivation of private interests automatically contributed to the larger public interest. Now, there is a marked tendency to advance the thought that the two interests are in conflict. In an address before the Federal Bar Association, an attorney general of the United States stated that "a respected private bar is engaged in the work of moulding the law slowly but steadily in the private interest." He then urged the Federal Bar, composed of lawyers working for governmental agencies, to "guide the processes of our courts in the direction of the public interests."

A newspaper commentator took issue with the suggested conflict between the advancement of private rights and its effect upon the public interest.[12] He called attention to our historical foundations and observed that neither the Declaration of Independence nor "the Constitution made mention of the 'public interest,' but the Constitution had much to say on the point of personal rights." He raised the question as to whether the creation of a distinct and separate "public interest" had been effected "to meet the need of a modern philosophy which sinks the individual and his personal rights in society."

Probably the concept of a public interest evolved in response to numerous conditions utterly unlike those that existed at the time of this nation's founding. In our early history, ownership and control were essentially bilateral; and agriculture represented the larger part of our economy. Today, there is marked separation between ownership and control; and large industry, with its attendant urban life, creates an entirely different economic framework. Call it "public interest," or devise other terminology, there has come into being a new set of problems which have seemed to change the character of "private interest." In fact, private interests turned to government of their own accord for assistance. Because of this combination of circumstances, a *fait accompli* must now be recognized, viz., a common and pronounced recognition of broad public rights.

As has been observed, the public interest has become cause for intrusion within long-recognized private reservations. Our chief hope for the preservation of the vitality and virtues of private interest cannot come from

[12] Thomas F. Woodlock, "Thinking It Over," *Wall Street Journal*, February 5, 1940, p. 4.

simple reverence for the past; rather, private industry must deal with the facts at hand and prove its superiority. By this means, the chief support of private enterprise—public opinion—will come to its defense.

External Responsibility. Consideration may now be given to corporate responsibility for the functioning of the entire economy. Naturally, private management will seek at all times to promote its own interests; but these are affected by such broad phenomena as unemployment, depressed agricultural conditions, currency and credit inflation, etc. Should the individual business take action to modify these larger influences, which are, in a sense, foreign to its own specific operation? Under a truly competitive economy, there would appear to be little occasion to embark on such ventures; but all of us are aware of the many compromises with vigorous competition. Moreover, public opinion and governmental policy play a large part in determining the answer. Recent trends of thought show that attention is being directed particularly to two types of external responsibility: (1) stabilization of business and (2) provision for social security.

THE STABILIZATION OF BUSINESS

In the opinion of many persons, the stabilization of business is both desirable and necessary to solve existing problems. At this point, it is not necessary to consider the merits of this proposition; and our comments may be confined to the question of the responsibility of corporations to make it effective. Heretofore, the business cycle was virtually taken for granted; and the main task of business enterprise was to adapt itself to the changes. Today, business is being held liable for the cycle and is being told that it must assume its share of the leadership in disposing of the phenomenon. It is declared that wage policies, dividend policies, programs of expansion, and other aspects of corporate activity affect social welfare and must be established with due consideration to their effect upon the activity of the whole.

The validity of the foregoing philosophy is, of course, open to question. Is not the corporation's chief concern the prudent utilization of funds committed to it by stockholders, bondholders, and various other claimants? Does it not partake of the nature of an ordinary trustee in which its first duty is to provide for the protection of the trustor's rights? Clearly, these are questions not simply of finance; they involve the very essence of our whole economic system. Nevertheless, it will be observed that the answers will take form largely in financial language. In the first place, the earnings of business enterprise would be vitally affected by any attempt on the part of individual business units to iron out extreme fluctuations. Secondly, these changes would be transmitted to the various equities; and, as a result, their values would be affected.

Some business leaders believe that stabilization would be an aid to

earnings by virtue of the elimination of numerous uncertainties which play havoc with both gross and net income. Testifying before the Temporary National Economic Committee, the president of the Anaconda Copper Mining Company suggested a program of industry co-operation under governmental supervision.[13] In essence, the various companies of a particular industry would be permitted to formulate a specific agreement to control prices and production. The agreements would be open to public inspection and subject to review by the federal courts. Unlike the ill-fated program provided under the National Industrial Recovery Act, the *rapprochement* of competing business units would be voluntary. It was proposed that the federal government scrutinize these industrial agreements but that its review not be carried to the point of active regulation. Obviously, revision of the antitrust laws would be necessary to permit industry co-operation of this type.

In a similar vein, it is reported "that the choice we have been facing for many years is not between pioneer individualism and state socialism, but is a choice between self-government in industry, under a limited but necessary governmental supervision, and a complete political control of industry."[14] Here, it will be noted that some form of control is taken for granted—the alternative being one of private or political sponsorship. Confronted with such proposals, the broader questions of policy become apparent. Under competition, there is little occasion for governmental interference, since price and output are determined by market action. But under any system of control, there appears the challenge of the right by which it may be assumed by private sources. Can it be assumed that private incentive will function to public advantage when no longer subject to competitive pressure?

THE NEED FOR PRESERVING COMPETITION

Stabilization too often becomes a fetish with its own brand of self-righteousness, and there are dangers of inflexibility which may prove costly in the long run. Moreover, it may easily degenerate into a form of special-interest favoritism at the expense of the more important and broader public interest. Most proponents of self-governed industry control recognize the need for some degree of governmental supervision, but it is usually of a passive variety.

There is also need to question both the desirability and the feasibility of stabilization. At what level should we attempt to stabilize? May adjustment be effected to meet changing needs? Questions of this type sug-

---

[13] *Verbatim Record of Proceeding of the Temporary National Economic Committee, January 15–February 17, 1940* (Washington, D.C.: U.S. Government Printing Office, 1940), p. 79.

[14] Address of Donald R. Richberg before National Automobile Dealers' Association, *Congressional Record*, Appendix, February 7, 1940, p. 1859.

gest many difficulties which are inherent in programs of control. What, then, is the solution? Under the public policies of recent times, various governmental measures have been utilized to hold the inevitable economic adjustments within reasonable bounds and, furthermore, have proven to be quite successful. At the same time, we may express the view that the essence and force of private competition must be preserved if we are to maintain a balance between private and public interests. Its merits and values are given practical and realistic expression in the following "declaration of faith":

> I don't know anything better. . . . I don't find that the countries which have abandoned competition are satisfied with their condition. Competition is the driving force in economy. I can't help but feel that some part of our failure to use our greater resources is due to the decline of competition. I would like to see, as a matter of experiment, a realistic attempt to put some of our basic industries on a competitive basis by withdrawing some of the sources of their monopolistic power.[15]

Also, in the message of the President of the United States to the Congress, in April, 1938, which finally led to the creation of the Temporary National Economic Committee, there is noteworthy recognition of the principles of competition. Speaking of events abroad, the following "two simple truths about the liberty of a democratic people" were set forth:

> The first truth is that the liberty of a democracy is not safe if the people tolerate the growth of private power to a point where it becomes stronger than their democratic state itself. That, in its essence, is fascism—ownership of government by an individual, by a group, or by any other controlling private power.
>
> The second truth is that the liberty of a democracy is not safe if its business system does not provide employment and produce and distribute goods in such a way as to sustain an acceptable standard of living.[16]

Because of these dangers, the President recommended "a thorough study of the concentration of economic power in American industry and the effect of that concentration upon the decline of competition." Speaking further of the program to investigate the concentration of business, the following quotations from this address reflect the values of competition:

> . . . It is a program whose basic thesis is not that the system of free private enterprise for profit has failed in this generation, but that it has not yet been tried.
>
> . . . It is a program to preserve private enterprise for profit by keeping it free enough to be able to utilize all our resources of capital and labor at a profit.

---

[15] Statement of Leon Henderson, as reported in the *Commercial and Financial Chronicle*, December 30, 1939, p. 4110.

[16] *Hearings before the Temporary National Economic Committee* (75th Cong., 3d sess.), Part I: Economic Prologue, December 1-3, 1938 (Washington, D.C.: U.S. Government Printing Office, 1939), p. 185.

. . . It is a program whose basic purpose is to stop the progress of collectivism in business and turn business back to the democratic competitive order.[17]

Competition imparts to the national economy a vigor that is not found under control programs. Under the latter, privilege and favoritism are bound to appear, with resulting inbreeding of weakness. There is a perpetuation of the *status quo,* so that survival is determined by sanction of authority. In marked contrast, competition forces continuous weeding-out of the unfit and places a premium on the ruggedness of each separate unit. And individual solvency is prerequisite to the solvency of the whole. This emphasis upon the single business unit may accentuate the adoption of conservative business policies in periods of depression; but, assuming effective competition, unwise expansion should be curbed in periods of boom. In large measure, the competitive process accepts business adjustment as inevitable but provides its own corrective agent in the form of price changes. However, viewing current political and economic thought, there appears to be little prospect for the exercise of full and free competition in the near future.

PROVISION FOR SOCIAL SECURITY

Another response to the uncertainties of business is found in the increasing demand for social security. Unfortunately, its underlying doctrine is often predicated upon a curtailment of individual opportunity and freedom. It is not always the intent to limit the scope of free enterprise, but the taxes and legal restrictions which are a part of the social security program serve to restrain business activity in many ways. Indeed, social security tends to become the supreme objective rather than permitting the degree of security to be determined by the capacity of business to support it. In a similar vein, numerous proponents of various social security devices are inclined to regard them as a means of creating prosperity.

There is now little question that business enterprise must participate in providing for the various contingencies which give rise to insecurity. Unemployment insurance, provision for old age, and various forms of compensation insurance are already in common use, being financed by business directly or through joint action of government and private enterprise. Thus, in the case of the federal social security program, a tax is paid by the individual workers but is collected through the employer. When the program is in full operation, this tax will amount to 8½ per cent of wages up to a stated amount (currently $4,800)—4¼ per cent to be borne by the employees and 4¼ per cent by the employers.

It is inopportune to discuss in this volume the many ramifications of social security, our chief interest being confined to the character of the

[17] *Ibid.,* p. 191.

corporate responsibility for this social burden. Action already taken bespeaks its formal recognition, and the main issue which remains is the extent to which business corporations will be called upon to finance the various aids to security. In the last analysis, public opinion will decide the question; and the actual realization of the security benefits will depend upon the ability of the business economy to carry the load.

GOVERNMENT RESPONSIBILITY

Under a competitive system, it may appear that very little room is left for action by government. On the contrary, there is imposed upon government and its agencies the most dignified and essential task of all—that of supervising competition. Because of the rivalry it stimulates, there is need for an umpire who will enforce the rules of fair conduct as well as require the observance of minimum standards. The government is peculiarly fitted to play this role as well as to take steps to raise the level upon which the game of business is being staged. Consideration may be given to the relationships that exist between business and government during the three possible stages of corporate life: (1) the promotion of business enterprise, (2) the operation of business enterprise, and (3) the failure and reorganization of business enterprise.

Promotion and the Government's Responsibility. Until recent years, it was not unusual to consider losses by investors as a legitimate and normal cost of promotion. It was expected that investors would carry the usual business risks and, in return, be entitled to the profits of appreciation and normal operating earnings. In performing this function, investors have every right to expect protection against fraud and other forms of deceit. The facilities that are required to render this protective service are essentially of a policing character and logically fall within the realm of governmental activity. Therefore, governmental supervision of promoting ventures is proper and should be so effective that wildcat or fly-by-night attractions are almost an impossibility. Reference has already been made to the Securities Act of 1933 and the Securities Exchange Act of 1934, which are serving to reduce the numerous unfair and deceptive practices so prevalent prior to their enactment.

The patrolling of promotional activities has, for the most part, been confined to the issuance of securities. The effectiveness of this surveillance, however, is vitally affected by the fact that corporate charters are granted by the individual states. To have the powers of the corporation emanate from one source and regulation from another obviously lessens the potency of governmental influence. Giving consideration particularly to interstate commerce, the arguments in favor of federal incorporation are clear and forceful. The usual arguments are advanced against this further centralization of power, but it should afford many advantages to both government and business. For the former, it should bring about

much-needed co-ordination of supervisory practice; to the latter, benefits would accrue through increased uniformity and certainty of requirements to be met.

The lessening of competition has served not only to remove many familiar checks on business; but, equally significant, it has destroyed many of the incentives to promote new business. There is a bare possibility that government eventually may find it necessary to offer inducements to initiate new enterprise. Pointing in this direction is the insurance of loan risks, described in Chapter 17; and in other instances, the government has assumed the role of investor. Conceivably, such aid may take the form of outright subsidies; or, to go still further, the state may assume the role of entrepreneur. Again, let it be said that the writers are not expressing their personal preference but are simply trying to interpret the developments of recent years.

Government and the Operation of Business Enterprise. The government, either state or federal, has long played a direct and prominent part during the inception and termination of a corporation. Throughout the active and operating life of an enterprise, there was little interference as long as any organization did not run afoul of the law. Business has been compelled to live up to various requirements in the way of industrial insurance, taxes, sanitary and working standards, etc.; but, at the same time, management has been allowed a comparatively free hand. For the most part, the state played a negative part and did little along positive and aggressive lines.

Recent tendencies give some indication that, in the future, the state may assume a more important voice in the policies of various industries, if not of the individual companies. The National Industrial Recovery Act, more familiarly known as the N.I.R.A., was distinctly a step in this direction. Minimum wages were established, prices were controlled, output was regulated, and various other forms of standardization were required; individual management was distinctly limited in the exercise of independent judgment. The Supreme Court declared the act to be unconstitutional, but numerous other legislative measures have served in less blanket fashion to affect corporate policy. The tax on undistributed profits, no longer in effect, had material influence upon dividend policies; and the existing laws decreeing minimum wages and maximum hours necessarily affect the decisions of private management.

This increasing control is undoubtedly the result of public opinion; but it is also a *quid pro quo*—the assumption of a voice by government in exchange for aid often requested by industry itself. Purely on the basis of logic, business must expect continued exercise of governmental influence if it continues to receive public funds. Bankers have long made control an incident of investment, and it should not occasion surprise to have government respond in a similar manner. At the same time, fairness demands that government accept the risks on a par with comparable

owners of private rights. Businessmen may charge that "government control of business masquerading under the term 'regulation' is stifling private enterprise and genuine recovery," but private business must demonstrate an ability to operate on its own if it is to avoid government interference.

Government and the Failure of Business Enterprise. The government takes the role of either the family doctor or the undertaker when the business unit gets into difficulties. Thus, receivers or trustees may be appointed by the court either for purposes of reorganization or for bankruptcy proceedings. Modification of the bankruptcy laws was prompted, no doubt, because of the wreckage resulting from the depression; but, in addition, it also reflects a growing recognition of the rights of small investors. Government clearly has a moral obligation to assure fair and equitable treatment of claimants against companies in default. The sharpening of this governmental responsibility in recent years should contribute materially toward safeguarding private rights and toward promoting the public interest.

In earlier chapters, the various steps which have been taken to facilitate the process of reorganization and bankruptcy have been discussed. Judged in the light of earlier standards, there appears to be some weakening of minority rights. Plans of reorganization may be forced upon recalcitrant participants when the court deems the overhauling to be beneficial to the larger group. It is hazardous to formulate a broad generalization about the ultimate effects of this curtailment of individual prerogatives, but it may be observed that clear recognition of property rights is essential to an orderly business process.

Investment represents a long-term commitment which rests upon an undergirding structure of confidence. In turn, this confidence is developed in large measure on the basis of reasonable expectation that adequate facilities are assured for the protection of the rights of the obligee against the obligor. The measures that have been adopted to safeguard the vast army of small investors should serve to stimulate confidence. More questionable is the tendency toward the weakening of the rights that accrue through priority of lien. It is difficult to forecast the ultimate repercussions of the involuntary modification of contractual rights. Much of the expected reaction to date has been prevented by easy money conditions as well as hidden by the greater magnitude of pressing social problems.

SUMMARY STATEMENT

As the memorable depression of the thirties and the devastating world war of the forties fade into the background, it is easy to hope that private business will return to its original position in the national economy. Both political conditions and the state of economic prosperity will affect

future developments; but, thus far, there is little evidence of any weakening in the ultimate and final responsibility of government. The kernel of new thought is deeply imbedded in our present society; and it is probable "that the mass of citizens has come to expect and indeed, as voters, to demand of their Federal Government a more active role of leadership in dealing with matters which affect the Nation's economic life."[18]

Giving specific evidence of the current position of the government in economic affairs is the Employment Act of 1946. Passed in the Senate by a unanimous vote and in the House of Representatives by a vote of 320 to 84, we may assume this act is generally accepted. Its stated purpose is "to declare a national policy on employment, production, and purchasing power, and for other purposes."[19] To these ends, it provides "that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, . . . to coordinate and utilize all its plans, functions, and resources, . . . to foster and promote free competitive enterprise and the general welfare. . . ."[20]

The act also created a Council of Economic Advisers to the President to assist and advise the President in the development of economic policies. The President submits to the Congress an annual *Economic Report*, which is made the subject of particular study by a Joint Committee of the Economic Report, composed of seven members from the Senate and seven members from the House of Representatives. While no legislative enactments may be traced directly to the annual reports, they undoubtedly have had influence upon statutory measures dealing with the purpose of the act.

As we peer into the unknown future, we can be certain of only one feature—there will be change. No one has the prescience to predict its nature but, inevitably, social and business patterns will be affected. The accompanying problems will present many challenges to business management; but, at the same time, they contain the seeds of opportunity. In meeting the demands of the future, we believe that finance will play a prominent role; but, as discussed in the first chapter, there should be clear recognition of one basic principle—finance is a force of both accommodation and discipline.

QUESTIONS AND PROBLEMS

1. "Among the many contrasts between World War I and World War II nothing is more remarkable than the profound change in economic thinking, and in the climate of public opinion throughout the world" (Alvin H. Hansen in "Stability and Expansion," chap. v of *Financing American*

---

[18] Council of Economic Advisers, *First Annual Report to the President, December, 1946* (Washington, D.C.: U.S. Government Printing Office, 1946), p. 1.

[19] P.L. 304, 79th Cong., 2d sess., February 20, 1946.

[20] *Ibid.*, sec. 2.

Prosperity—A Symposium of Economists [New York: Twentieth Century Fund, Inc., 1945], p. 199). Discuss.

2. It is reported that "there occurred a decline of private capital outlays from the annual rate of $17,000,000,000 in 1929 to $2,000,000,000 in 1932." Do you think the government should have remained passive under such conditions?
3. Discuss the possibilities of private business management assuming a "career status."
4. Discuss the observation on p. 733 that ". . . the ability of the American economy to sustain orderly growth, to generate useful employment, to provide sufficient real capital to finance expansion, and to function as a source of strength for the entire free world, all depend on the maintenance of financial responsibility."
5. "Since, in the modern industrial state, no government is immune from responsibility for a measure of the economic well-being of its population, the large corporation, particularly in basic industry, inevitably assumes a relationship to the formal or informal political structure" (A. A. Berle, Jr., "Corporations and the Modern State," in *The Future of Democratic Capitalism* [Philadelphia: University of Pennsylvania Press, 1950], pp. 36–37). Discuss.
6. What is meant by the statement on page 736 of the text that "corporations have generally pursued a policy of isolationism"?
7. Do you think it is possible for corporations to assume a broad responsibility for the welfare of society and at the same time do justice to the interests of stockholders and of other investors?
8. "If it be contended that government supervision of private business is necessary, then the question may be raised as to who is going to supervise government." Discuss.
9. "Unfortunately, in both government and business, personalities too often decide issues instead of the merits of the facts." Explain and discuss.
10. In your opinion, is the stabilization of business inconsistent with the principles of a competitive economy?
11. Do you believe that government lending agencies should have the power to change the management of private borrowers as a condition for a loan?
12. Do you think that the federal government has a responsibility to prevent and to eliminate unemployment?
13. Why is public policy "a very unruly horse"? Discuss the need for checks and balances on government controls.
14. Discuss the difficulties of a free market in recent times.
15. In passing sentence in early 1961 upon the violation of price-fixing laws by various electric companies, the judge declared the actions to be "a shocking indictment of a vast section of our economy . . ." and that ". . . the real blame is to be laid at the doorstep of . . . those who guide and direct . . ." the policy of the corporations. Discuss.
16. Discuss the purpose of the Employment Act of 1946 as stated on p. 747.

REFERENCES

BERLE, ADOLPH A., JR. *The Twentieth Century Capitalist Revolution.* New York: Harcourt, Brace & Co., 1954.

Berle, Adolph A., Jr. and Means, G. C. *The Modern Corporation and Private Property*. New York: Macmillan Co., 1933.

Bowen, Howard R. *Social Responsibilities of the Businessman.* New York: Harper & Brothers, 1953.

Buchanan, N. S. *The Economics of Corporate Enterprise*, chap. xv. New York: Henry Holt & Co., Inc., 1940.

Committee for Economic Development. *The Problem of Changeover Unemployment.* New York, 1945.

———. *Testimony of Paul G. Hoffman on Government Policy to Prevent Depressions.* New York, 1947.

Corson, John J. "MORE Government in Business," *Harvard Business Review*, Vol. XXXIX, No. 3 (May–June, 1961), pp. 81–88.

Council of Economic Advisers. *First Annual Report to the President, December, 1946.* Washington, D.C.: U.S. Government Printing Office, 1946.

Drucker, Peter F. *Landmarks of Tomorrow*, chaps. vi and ix. New York: Harper & Brothers, 1959.

Economic Report of the President to the Congress, January 8, 1947. Washington, D.C.: U.S. Government Printing Office, 1947, and ensuing reports.

The Future of Democratic Capitalism. Philadelphia: University of Pennsylvania Press, 1950.

Gordon, R. A. "Financial Control of Large Scale Enterprise," *American Economic Review*, Supplement, March, 1939, pp. 85–99.

———. "Ownership by Management and Control Groups in the Large Corporation," *Quarterly Journal of Economics*, Vol. LII (1938), pp. 367–400.

Midyear Economic Report of the President to the Congress, July 21, 1947. Washington, D.C.: U.S. Government Printing Office, 1947.

Snyder, Carl. *Capitalism the Creator.* New York: Macmillan Co., 1940.

Twentieth Century Fund, Inc. *Financing American Prosperity—A Symposium of Economists.* New York, 1945.

Watson, Donald Stevenson. *Economic Policy: Business and Government.* Boston, Mass.: Houghton Mifflin Co., 1960.

Index

INDEX

Q

R

S

This book has been set on the Linotype in 9 and 10 point Janson, leaded 2 points. Chapter titles and part numbers are in 18 point Lydian. Chapter numbers are in 18 point Lydian Cursive and part titles are in 24 point Lydian Cursive. The size of the type page is 27 by 47 picas.